(13)

No. 90-1491-CFX
Status: GRANTED

Title: Union Bank, Petitioner
v.
Herbert Wolas, Chapter 7 Trustee for the Estate of ZZZZ Best Co., Inc.

Docketed:
March 26, 1991

Court: United States Court of Appeals for the Ninth Circuit

Counsel for petitioner: Graham,John Albert

Counsel for respondent: Wolas,Herbert

Entry	Date	Note	Proceedings and Orders
1	Mar 26 1991	G	Petition for writ of certiorari filed.
2	Apr 10 1991		Brief of respondent Herbert Wolas, etc. in opposition filed.
3	Apr 17 1991		DISTRIBUTED. May 9, 1991
4	Apr 24 1991	G	Motion of California Bankers Association for leave to file a brief as amicus curiae filed.
5	May 13 1991		Motion of California Bankers Association for leave to file a brief as amicus curiae GRANTED.
6	May 13 1991		Petition GRANTED.
			**
8	Jun 13 1991		Order extending time to file brief of petitioner on the merits until July 9, 1991.
9	Jul 8 1991		Brief of petitioner Union Bank filed.
10	Jul 8 1991		Joint appendix filed.
11	Jul 9 1991		Brief amicus curiae of Robert Morris Associates filed.
12	Jul 9 1991		Brief amici curiae of American Council of Life Insurance, et al. filed.
13	Jul 9 1991		Brief amicus curiae of New York Clearing House Assn. filed.
14	Jul 9 1991		Brief amicus curiae of California Bankers Association filed.
16	Jul 25 1991	G	Motion of American Bankers Association for leave to file a brief as amicus curiae filed.
15	Jul 30 1991		Brief of respondent Herbert Wolas, etc. filed.
17	Aug 21 1991		CIRCULATED.
18	Aug 27 1991	X	Reply brief of petitioner Union Bank filed.
19	Sep 5 1991		SET FOR ARGUMENT TUESDAY, NOVEMBER 5, 1991. (4TH CASE)
20	Sep 20 1991		Motion of American Bankers Association for leave to file a brief as amicus curiae GRANTED.
21	Oct 24 1991		Record filed.
		*	Certified proceedings and briefs, United States Court ofAppeals, Ninth Circuit.
22	Oct 29 1991		Record filed.
		*	Original proceedings United States District Court, Central District of California. (Box)
23	Nov 5 1991		ARGUED.

1 PM

90-1491

No. ———

FILED
MAR 26 1991
OFFICE OF THE CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1990

UNION BANK,
Petitioner,
v.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,
Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

PETITION FOR WRIT OF CERTIORARI

JOHN ALBERT GRAHAM
Counsel of Record
LESLEY ANNE FLEETWOOD HAWES
FRANDZEL & SHARE
A Law Corporation
6500 Wilshire Boulevard
Seventeenth Floor
Los Angeles, California 90048-4920
(213) 852-1000

STEPHEN H. WEISS
Senior Vice President and
Deputy General Counsel
Office of the General Counsel
UNION BANK
445 South Figueroa Street
Los Angeles, California 90071-1602
(213) 236-5906
*Attorneys for Petitioner,
Union Bank*

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTIONS PRESENTED

1. Bankruptcy Code § 547(c)(2) protects otherwise preferential payments from recovery by a trustee in bankruptcy if the payments are (a) made on a debt incurred in the ordinary course of business of the debtor and the creditor, (b) made in the ordinary course of business, and (c) made in accordance with ordinary business terms. Did the Ninth Circuit err in devising an unwritten limitation to the protection granted creditors under Bankruptcy Code § 547(c)(2); or, did the Sixth, Seventh and Tenth Circuits correctly apply Bankruptcy Code § 547(c)(2) in accordance with its plain meaning because literal application of the statute is not demonstrably at odds with the intention of Congress?

If the Court concludes that § 547(c)(2) draws a distinction between payments on short-term debt, which are protected, and payments received on long-term debt, which are not, then the following additional question is presented for determination:

2. Did the Ninth Circuit err by failing to define "long-term" debt in accordance with generally accepted accounting principles, income tax rules, and the general course of dealing in business transactions, thereby denying commercial lenders the protection of Bankruptcy Code § 547(c)(2)?

LIST OF PARTIES

The parties to the proceedings below were the Petitioner, Union Bank, and the Respondent, Herbert Wolas in his capacity as Chapter 7 Trustee of the bankruptcy estate of ZZZZ Best Co., Inc.

Union Bank is a corporation organized under the laws of the state of California to conduct business as a banking institution. Union Bank's parent corporation is The Bank of Tokyo, Ltd. Union Bank has no subsidiaries, other than wholly owned subsidiaries.

TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

In The

Supreme Court of the United States

October Term, 1990

No. ——

Union Bank,
Petitioner,

v.

Herbert Wolas, Chapter 7 Trustee for the Estate of ZZZZ Best Co., Inc.,
Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

Union Bank, the Petitioner herein, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on December 28, 1990.

OPINIONS BELOW

The December 28, 1990 opinion of the Court of Appeals for the Ninth Circuit reverses the judgments of the district and bankruptcy courts. The opinion is reported at 921 F.2d 968 and reprinted as Appendix A to this Petition, at 1a.

On August 8, 1989, the District Court for the Central District of California entered its Order Affirming Judgment, affirming the summary judgment of the bankruptcy court granted in favor of the Petitioner, Union Bank. The district court order was appealed by the Respondent to the court of appeals. The district court order was not published and is reprinted as Appendix B to this Petition, at 3a.

The order of the Bankruptcy Court for the Central District of California granting summary judgment in favor of the Petitioner, from which appeal was taken by the Respondent to the district court, was not published. The bankruptcy court's Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief, entered August 23, 1988, and Findings of Fact and Conclusions of Law related thereto, are reprinted in Appendices C and D to this Petition, respectively, at 6a and 10a, respectively.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was entered on December 28, 1990, reversing the judgments in favor of the Petitioner entered by the district court and the bankruptcy court. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED

This case involves a lawsuit filed by Respondent, a Bankruptcy Trustee, to recover from Union Bank certain monthly interest payments and a small monthly loan fee as preferential transfers under § 547(b) of the Bankruptcy Code, Title 11 of the United States Code. Section 547(b) provides:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would have received if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

There are exceptions to the trustee's ability to avoid certain transfers under 11 U.S.C. § 547 that are set forth in § 547(c). The exception upon which the Petitioner has relied to defend against the Trustee's preference action is § 547(c)(2), which provides as follows:

> The trustee may not avoid under this section a transfer—
>
> . . . .
>
> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms.

STATEMENT OF THE CASE

This case involves a fact pattern that occurs routinely in almost every one of the hundreds of thousands of bankruptcy cases filed each year throughout the United States: a creditor has received ordinary monthly payments on its obligation within the applicable preference period prior to the bankruptcy filing. These payments are subject to recovery by the trustee or debtor-in-possession as avoidable, preferential transfers.[1] At issue is the proper interpretation and application of a statutory exception to the trustee's preference avoiding powers for "ordinary course of business" payments on which *the courts of appeals of four circuits are divided.* The resolution of the dispute among the circuits will have profound ramifications for financial institutions which are the constant targets of preference claims and which will be left unprotected by the "ordinary course of business" exception in bankruptcies filed in jurisdictions governed by the Ninth Circuit if the court's ruling in this case is allowed to stand.[2]

---

[1] According to statistics compiled by the Administrative Office of the United States Courts, there were 782,960 bankruptcy petitions filed in 1990, and 57,231 adversary proceedings were initiated. Since the preference law is one of a bankruptcy estate's primary avoiding powers, it is fair to assume that a large number of those adversary proceedings were preference actions. *Twenty-two percent* (170,102) of the nation's bankruptcy cases filed in 1990 were filed in the Ninth Circuit, illustrating the profound effect of the Ninth Circuit's ruling in this case.

[2] The Ninth Circuit's decision in this case relies on and adopts its prior decision in *Matter of CHG Int'l, Inc. (CHG Int'l, Inc. v. Barclays Bank)*, 897 F.2d 1479 (9th Cir. 1990), which decision was rendered after Union Bank had prevailed in the bankruptcy and district courts and the matter had already been fully briefed in the court of appeals. When the *CHG Int'l* opinion was issued, the Trustee asserted that *CHG Int'l* controlled the disposition of this case because the loan in question was a long-term loan that as a matter of law under *CHG Int'l* was not entitled to the protections of § 547(c)(2). Union Bank preserved its rights by disputing both the applicability of *CHG Int'l* and the court's interpretation of the "ordinary course of business" exception. Union Bank requested an *en banc* hearing and specifically objected to the court's ruling that long-term debt is not within the scope of § 547(c)(2) notwithstanding the absence of statutory language or legislative history to support that proposition.

To avoid a transfer of property as a preference the Bankruptcy Code requires the trustee to demonstrate that the transfer was made on account of an antecedent debt and permitted the creditor to receive more than it would have received in a Chapter 7 liquidation. 11 U.S.C. § 547(b). However, even if the trustee establishes each of the elements of a preferential transfer under § 547(b), the Bankruptcy Code exempts certain preferential transfers from recovery by the estate.

The preference recovery exception at issue in this case is the provision that exempts "ordinary course of business" payments from avoidance. The creditor must demonstrate that (a) the debt was incurred in the ordinary course of the debtor's and the creditor's business or financial affairs, (b) the payment was made in the ordinary course of business or financial affairs of the debtor and the creditor, and (c) the payment was made in accordance with ordinary business terms.

The loan in this case was a $7 million unsecured revolving line of credit with an eight-month term. The Petitioner Bank received regular monthly interest payments, drawn from the debtor's checking account under an automatic debit agreement, and small monthly loan commitment fees that were calculated based upon the portion of the unused credit available under the line.

Whether the two monthly payments received by Union Bank which the Respondent Trustee sought to avoid met

the "ordinary course of business" exception of § 547 (c)(2) was brought to the bankruptcy court for determination through cross-motions for summary judgment. The Bank presented unrefuted evidence that the loan to the debtor was made strictly in accordance with the Bank's ordinary procedures and guidelines for such extensions of credit and that, based upon the financial statements, projections and other information submitted to the Bank, the line of credit was within the amount of credit that would be expected to be extended to a company of the size and profitability set forth in the financial data. The Bank also presented unrefuted evidence that the method of payment through the automatic debiting of the debtor's checking account maintained at the Bank was an ordinary and customary method of payment that many commercial customers of the Bank use for convenience, and the monthly interest payments and loan commitment fees were ordinary types of payments routinely required in commercial loans.

The bankruptcy court ruled that the two monthly payments received by the Bank within 90 days of the bankruptcy were ordinary course of business payments under each prong of § 547(c)(2) and therefore the payments could not be avoided. Following entry of the bankruptcy court's judgment, the Respondent Trustee perfected an appeal to the United States District Court for the Central District of California.[3] The district court affirmed. The Respondent Trustee appealed the district court's ruling to the Court of Appeals for the Ninth Circuit.[4] A three-judge panel of the Ninth Circuit

[3] The jurisdiction of the district court to consider the appeal is provided by 28 U.S.C. § 158(a) which grants the district court jurisdiction to hear appeals from final judgments of the bankruptcy courts.

[4] The Ninth Circuit's jurisdiction to hear the appeal is provided by 28 U.S.C. § 158(d) which grants the circuit courts of appeals jurisdiction to hear appeals from final decisions of the district courts entered pursuant to 28 U.S.C. § 158(a) and (b).

reversed in a per curiam opinion, relying on the decision of another panel of the court in *Matter of CHG Int'l, Inc. (CHG Int'l, Inc. v. Barclays Bank)*, 897 F.2d 1479 (9th Cir. 1990).

In *CHG Int'l*, the court held that payments made on *long-term debt do not qualify* for the protections of the "ordinary course of business" exception of § 547(c)(2) *as a matter of law*. The court in the *ZZZZ Best* decision held that the eight-month revolving line of credit constitutes "long-term" debt for the purposes of § 547 (c)(2) because one of the two debts in the *CHG Int'l* case had a term of seven months and was held to be long-term debt.

The holding in *ZZZZ Best* directly conflicts with the published opinions of three other circuits on the issue of whether payments on "long-term" debt are excluded as a matter of law from the protections of § 547(c)(2). In *In re Finn (Gosch v. Burns)*, 909 F.2d 903 (6th Cir. 1990), the Court of Appeals for the Sixth Circuit reversed a summary judgment granted in favor of the trustee which had permitted recovery of ordinary course payments on a long-term debt as preferential transfers despite the "ordinary course of business" exception. The Sixth Circuit held that nothing in the statute or the scant legislative history surrounding the present version of the statutory exception provided a basis for deviating from the plain meaning of the statute and excluding long-term debt from the coverage of § 547(c)(2) as a matter of law. The Sixth Circuit reasoned that the analysis of some courts and commentators that the statute applies only to short-term trade debt "imports too much *assumed history* into the barren language of the statute." (Emphasis added.) *Finn*, 909 F.2d at 907. Instead, the court in *Finn* found that "[b]y eliminating the 45-day limitation, *and neither stating nor implying any other limitation*, Congress's language left the field open to long-term consumer debt for exception under § 547(c) (2)." (Emphasis added.) *Finn*, 909 F.2d at 908.

The Ninth Circuit did not define what constitutes "long-term" debt. No analysis of the appropriate standard for determining what is long-term debt was made by the Ninth Circuit in either *CHG Int'l* or *ZZZZ Best.*[5] The court did not address the authorities cited by Union Bank that for accounting purposes and in business generally, "long-term" debt is considered to be debt with a term longer than one year. *See* S. Stern, *Structuring Commercial Loan Agreements* ¶ 6.03[1][b] (2d ed. 1990) (WG&L); RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, Accounting Research Bulletin No. 43, ch. 3 "Working Capital," § A7 (Am. Inst. of Certified Pub. Accountants 1953) (hereinafter "ARB 43").

The Court of Appeals for the Seventh Circuit has relied upon the availability of § 547(c)(2) to protect lenders from the recovery of ordinary loan payments made up to one year prior to the bankruptcy in ruling that a creditor holding the guaranty of an insider can be subjected to preference exposure for a full year preceding the commencement of the bankruptcy case. *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989), *aff'g in part and rev'g in part In re Deprizio Constr. Co.*, 86 Bankr. 545 (N.D. Ill. 1988) (hereinafter "*Deprizio*"). The Court of Appeals for the Tenth Circuit, relying on legislative history that the Ninth Circuit did not address or acknowledge in either the *ZZZZ Best* or *CHG Int'l* decisions, has ruled that § 547(c)(2) protects payments made on savings certificates with terms of up to one year and that § 547(c)(2) is applicable to credit other than trade debt. *Fidelity Sav. & Inv. Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989).[6]

[5] The vice of ignoring the statute's plain meaning is made obvious since creditors are left to guess at what constitutes "long-term" debt.

[6] There may also be a conflict with the Eighth Circuit based on its decision in *In re Iowa Premium Serv. Co., Inc. (Iowa Premium Serv. Co., Inc. v. First Nat'l Bank in St. Louis, etc.)*, 695 F.2d 1109 (8th Cir. 1982).

The court's ruling in *ZZZZ best* is also in conflict with this Court's decision in *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989), in which this Court held that the plain meaning of Bankruptcy Code provisions, as with other statutes, should be "conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.'" *Ron Pair*, 109 S. Ct. at 1031.

REASONS FOR GRANTING THE WRIT

In holding that the regular monthly interest payments on the eight-month commercial loan in this case are not protected as a matter of law under the "ordinary course of business" exception, the Ninth Circuit has rendered a decision that not only conflicts with the plain meaning of the statute and the rules of statutory interpretation established in this Court's decision in *Ron Pair* but also creates a direct conflict with decisions in the Sixth, Seventh and Tenth Circuits on the proper interpretation and application of § 547(c)(2) of the Bankruptcy Code. This conflict must be resolved as expeditiously as possible as the issue is one involving a national bankruptcy law that is intended to be uniformly applied to avoid forum shopping and the fortuity of the jurisdiction determining the result in a particular case. The Ninth Circuit's decisions in this case and the case on which it relied to reach its result, *CHG Int'l*, hold that payments on so-called "long-term" debt are not protected by § 547(c)(2); yet, the court failed to establish a definition of long-term debt, implicitly rejecting the traditional definition of long-term debt under generally accepted accounting principles which would signify a debt with a term of over one year. The lack of any standard in the Ninth Circuit for determining what constitutes a "long-term" debt excluded from protection under the Ninth Circuit's ruling leaves regulated financial institutions in a precarious position with no means of determining their po-

tential exposure to preference liability on existing loans and no way to guide their future conduct in establishing the terms of loans. This issue, which presents itself in almost every single bankruptcy proceeding, should not be the subject of conflicts among four circuit courts of appeals.

I. LACK OF UNIFORMITY IN THE CIRCUITS ON A FUNDAMENTAL ISSUE OF FEDERAL BANKRUPTCY LAW CREATES UNCERTAINTY AND RISKS FOR LENDERS THAT WILL BROADLY AND ADVERSELY IMPACT CREDIT TRANSACTIONS.

One of the primary purposes of the Court's certiorari jurisdiction is to ensure uniformity of decisions among the courts of appeals, particularly on an issue of federal law. *See, e.g., Arco Corp. v. Aero Lodge 735*, 390 U.S. 557, 559, 88 S. Ct. 1235, 20 L. Ed. 2d 126 (1968); *Northeastern Nat'l Bank v. U.S.*, 387 U.S. 213, 217, 87 S. Ct. 1573, 18 L. Ed. 2d 726 (1967); *Magnum Import Co. v. Coty*, 262 U.S. 159, 163, 43 S. Ct. 5311, 67 L. Ed. 922 (1922). The issue presented in this case not only involves a square conflict among four circuits; the case also involves an important issue *fundamental* to bankruptcy that arises in virtually every bankruptcy case since typically debtors have made at least some ordinary course payments prior to their petition. *New York v. Saper*, 336 U.S. 328, 329, 69 S. Ct. 554, 93 L. Ed. 710 (1948) (conflict related to a matter "of considerable practical importance in the administration of the Bankruptcy Act" and certiorari was therefore granted). Further, the issue is one that will continue to present itself in the future in the hundreds of thousands of bankruptcy cases that are filed each year. The conflict is one that will not disappear, as the Ninth Circuit in *ZZZZ Best* was given a clear opportunity to alter its ruling to conform to the opinions of the Sixth, Seventh, and Tenth Circuits and chose not to do so.

The decision for which review is sought will have enormous ramifications for lenders throughout the country. The decision encourages forum shopping by large corporate borrowers who may have a choice of jurisdictions in which to file their bankruptcy cases under 28 U.S.C. § 1408 and may therefore elect to file in the Ninth Circuit to recover ordinary course payments that could not be recovered under § 547(c)(2) if the case were filed in the Sixth, Seventh, and Tenth Circuits.

As interstate and multi-state lending transactions become more commonplace, it is essential that lenders be able to rely on the uniform treatment of their obligations under federal bankruptcy preference law. Lenders need to be able to predict with reasonable certainty the effect of the federal bankruptcy laws on their transaction. The uncertainty created by the split in the circuits, compounded by the potential for forum shopping, will restrict credit by forcing lenders to factor the risk of the lack of protection for ordinary course payments into their credit decisions. Further, because parties are prohibited as a matter of law from prospectively waiving the benefits of the bankruptcy laws, parties cannot negotiate contractual terms to protect lenders from the adverse result of the Ninth Circuit's interpretation of the ordinary course exception.

An irony of the Ninth Circuit's interpretation of the ordinary course exception is that the preference statute is concerned with equality of treatment and distributions among creditors with claims of similar priority. Yet, the effect of the *ZZZZ Best* decision and the split among the four circuits is to discriminate among lenders based solely on the length of the loan term and the jurisdiction of the case, even though the law that governs the dispute in each case is a national bankruptcy law. The inconsistency in the treatment of creditors under a federal law that was clearly intended to be uniformly applied demands prompt resolution by this Court.

II. THE *ZZZZ* BEST DECISION DIRECTLY CONFLICTS WITH DECISIONS OF THREE OTHER CIRCUIT COURTS, WITH THE "PLAIN MEANING" RULE OF STATUTORY CONSTRUCTION, AND WITH THE LEGISLATIVE HISTORY OF THE STATUTE.

A. The Failure to Accord Payments on Long-Term Debt the Protections of § 547(c)(2) Is in Conflict with the Plain Language of the Statute.

The hallmark of § 547(c)(2) is an "ordinariness" standard. There is no language in the statute from which a distinction can be drawn between short-term or trade debt and long-term or other commercial obligations, with only the former being protected from preference recovery. The Ninth Circuit did not suggest that the language of the statute itself supports its interpretation nor did the Ninth Circuit find that the language of the statute is ambiguous. In fact, the court of appeals acknowledged that the "literal" application of the statute would make no distinction whatsoever among loans according to the duration of the loan or the character of the credit so long as the "ordinariness" standard was satisfied.

For the Ninth Circuit to reject the language of the statute and read into the statute a condition not provided by its terms or mandated by the legislative history transgresses the principles of statutory construction articulated by this Court in numerous decisions, including the Court's recent decision in *Ron Pair*. The unambiguous terms of the statute must be deemed "conclusive" according to *Ron Pair* unless this is the "rare case" in which the application of the statute according to its literal terms would create "a result *demonstrably at odds* with the intention of its drafters." (Emphasis added.) *Ron Pair*, 109 S. Ct. at 1031. The scant legislative history that exists for this statute does not support a finding that application of its protections to payments on long-term

debt would violate the intent of Congress; in fact, the legislative history suggests that Congress specifically did not intend to limit the application of the statute to trade debt. Further, Congress did not indicate that any other reservations or restrictions were intended beyond those expressed in the terms of the statute itself.

B. The Scarce Legislative History Does Not Support the Artificial Limitations on the Applicability of the Exception Judicially Created in the *CHG Int'l* and *ZZZZ Best* Decisions.

Section 547(c)(2) was enacted as part of the Bankruptcy Code of 1978.[7] The goals of this exception to the preference rule were clearly identified by Congress:

> The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.

H.R. REP. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990); S. REP. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* App. 3 COLLIER ON BANKRUPTCY ch. V (15th ed. 1990).

The Ninth Circuit conceded that there is little legislative history accompanying the 1984 amendments to the Code that eliminated the 45-day rule. *CHG Int'l*, 897 F.2d at 1484. The Ninth Circuit further acknowledged that "*a literal . . . reading of the new section 547(c)(2) appears to remove the primary obstacle which excluded*

[7] The statute as originally enacted included the three existing requirements of the ordinary course of business exception and an additional requirement that the payment or transfer in question be made within 45 days of the date the debt was incurred. Congress later eliminated the 45-day requirement as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984.

these [long-term] loans from the exception."[8] (Emphasis added.) *CHG Int'l*, 897 F.2d at 1484.

This Court in its 1988 decision in *United Sav. Ass'n of Texas v. Timbers of Inwood Forest, Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988), made it abundantly clear that it is improper for a court to impute a significance to a statute from legislative history so as to alter the import of the explicit statutory language. As the Court stated in referring to the legislative history of the statutes at issue in that case, "*Such generalizations* [in the legislative history] *are inadequate to overcome the plain textual indication* in §§ 506 and 362(d)(2) of the [Bankruptcy] Code that Congress did not wish the undersecured creditor to receive interest on his collateral during the term of the stay." (Emphasis added.) *Timbers*, 484 U.S. at 380. Shortly after the *Timbers* decision, this Court reaffirmed the duty of the bankruptcy courts to enforce the Bankruptcy Code as written, prohibiting the courts from using their equitable powers to circumvent the unambiguous language of the provisions of the Code. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S. Ct. 968, 99 L. Ed. 2d 169 (1988) ("whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code").

The sparse legislative history that does exist indicates that Congress certainly intended that the statute protect payments made on obligations other than trade debt. For example, the protection of payments made on commercial paper is addressed in a colloquy between Senators DeConcini and Dole that was relied upon by the Tenth Circuit in reaching the conclusion, contrary to the Ninth Circuit's decision, that debts with a term of up to one

[8] In effect, based on the change in the statute, any loans or other obligations on which payment is made more than 45 days after the debt is incurred would be long term in this context.

year are protected by the ordinary course of business exception. *New Hope Baptist*, 880 F.2d at 1175-76, *citing* 130 CONG. REC. 20,091 (1984). This part of the legislative history was not addressed by the Ninth Circuit in either *CHG Int'l* or *ZZZZ Best*.

In the face of this limited legislative history and the explicit terms of the statute which include no restrictions on its application to short-term or trade debt, the Court of Appeals for the Sixth Circuit has reasoned that it is bound to enforce the statutory language of § 547(c)(2). In *Finn*, the Sixth Circuit held that there is no basis for excluding payments on long-term debt from the protections of § 547(c)(2) as a matter of law. This ruling directly conflicts with the Ninth Circuit rulings in *CHG Int'l* and *ZZZZ Best* that as a matter of law, such payments are not entitled to protection from recovery under the ordinary course of business exception.

In *Finn*, the Sixth Circuit evaluated the available legislative history surrounding the statute and directly responded to the commentators and courts that have taken the position that § 547(c)(2) applies only to short-term trade debt despite Congress's elimination of the 45-day rule:

> The problem with this analysis is that *it imports too much assumed history into the barren language of the statute*. On its face, the pre-1984 language applied to all debt incurred "in the ordinary course," and the limitation came from requiring the payment within 45 days of the debt. By eliminating the 45-day limitation, and neither stating nor implying any other limitation, Congress's language left the field open to long-term consumer debt for exception under § 547(c)(2). Some courts take the position, as *In re Control Electric*, that without legislative history to back it up, a change in the language of the statute is not to be respected. . . .
>
> We reject this method of statutory interpretation. *The position of the In re Control Electric*

court—that transfers made pursuant to long-term debt cannot be excepted from the avoidance provisions of § 547(b)—cannot be derived from the statutory language or legislative history, [emphasis added] and it is factually inconsistent with American credit practices today. The type of loan taken out by Finn in this case is, indeed, the life blood of credit unions such as hers and of commercial credit companies, and is an important part of the business of banks. Such a transaction can scarcely be "unusual" for *every* borrower [emphasis in original].

Finn, 909 F.2d at 907-08.

The decision of the Ninth Circuit rejecting the plain language of the statute has broad and devastating ramifications for lenders in the face of the Seventh Circuit's ruling in *Deprizio* and its reliance on the ordinary course of business exception to protect lenders from the harsh rule which it established in that case. *Deprizio* subjects a lender holding an insider guaranty to preference liability for payments made *during the entire year* prior to the petition rather than the usual 90-day period. The court in *Deprizio* responded to creditors' concerns that its ruling would substantially increase their exposure to preference liability with the statement that "It is enough to observe that § 547(b)(5) and (c), both before and after amendment, *exclude from recovery the bulk of ordinary commercial payments.*" (Emphasis added.) *Deprizio*, 874 F.2d at 1199. The court cited an example of the application of the ordinary course of business exception and its protection of routine payments on commercial loans as follows:

A creditor makes an unsecured loan guaranteed by an insider and requires monthly payments *over a number of years.* The trustee seeks to recover all of the payments during the year before the filing. To the extent the debtor paid on time, the creditor is protected by the current version of § 547(c)(2), the "ordinary course" rule. [Emphasis added.]

Deprizio, 874 F.2d at 1200.

The comfort to commercial lenders discussed in *Deprizio* will not be available to lenders in bankruptcy cases that are filed in the states governed by the Ninth Circuit if this Court does not grant this petition and overrule the Ninth Circuit's flawed construction of the "ordinary course of business" exception to the preference rule.

III. THE POLICIES OF THE PREFERENCE LAW AND ITS EXCEPTION FOR ORDINARY COURSE PAYMENTS DO NOT SUPPORT THE NINTH CIRCUIT'S REFUSAL TO APPLY THE EXCEPTION TO LONG-TERM DEBT.

The Ninth Circuit has identified two policies underlying the preference laws: to discourage a "race to the courthouse" and dismemberment of the debtor during the debtor's financial decline, and to equalize the distribution of assets of the estate among similarly situated creditors. In attempting to promote the latter policy, the Ninth Circuit ignored the effect of its decision on the former policy. The Ninth Circuit also erroneously concluded that depletion of the estate is avoided by a rule that protects only payments made on short-term debt and not long-term debt.

A. The Failure to Protect Ordinary Course of Business Payments on Long-Term Debt Creates a Strong Disincentive to Lenders to Work with a Struggling Debtor, Particularly in Light of *Deprizio*.

Although the Ninth Circuit specifically commented on the dual policies of the preference statutes, the court ignored the first policy of discouraging unusual action and pressure by a creditor as a debtor's financial condition declines when it ruled that ordinary payments on long-term debt should not be protected under § 547(c)(2). In light of the *Deprizio* ruling which subjects creditors with insider guaranties to preference liability for a one-year period prior to the bankruptcy, any delay by a creditor in asserting its rights at the first sign of the debtor's financial trouble is only likely to increase

the creditor's potential preference exposure. At the same time, the debtor's assets will be declining as it slides toward bankruptcy. There is no incentive for the creditor to not aggressively pursue repayment of the debt since the ordinary course payments will be recoverable by the estate in any event. The rule established by the court in *CHG Int'l* and *ZZZZ Best* thus defeats one of the two key policies the preference statutes are designed to promote and is inconsistent with the express concern of Congress that "normal financial relations" be left "undisturbed." H.R. REP. NO. 595, 95th Cong., 1st Sess. 373-74 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990); S. REP. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* App. 3 COLLIER ON BANKRUPTCY ch. V (15th ed. 1990).

B. Avoiding Depletion of the Estate Is Not Accomplished by the Ninth Circuit's Rule.

The estate is equally depleted by payments on short-term and long-term debt made during the preference period. Regardless of when the consideration underlying the preferential payment is transferred to the debtor, the estate is still depleted when the preferential payment is ultimately made to the creditor. Although § 547(c)(2) is designed to encourage creditors to continue to provide a financially troubled debtor with credit, the statute actually only protects the creditor who ultimately is preferred by allowing the creditor to retain the preferential transfer.

By allowing the working capital under Union Bank's line of credit to remain with the debtor in consideration of the receipt of the regular monthly interest payments, Union Bank has done as much or more to "replenish" the estate than the hypothetical "short-term" trade creditor that has supplied goods to the business prior to the petition and been paid in full for the goods supplied. Indeed, Union Bank "replenished" the estate in the sum of $7,000,000 within seven months of the bankruptcy—the trade creditors' contribution to the debtor's estate paled in comparison.

Further, Congress made it clear in the limited legislative history under the 1984 amendments that it intended the elimination of the 45-day rule to protect payments made on commercial paper; yet those payments would clearly deplete the estate just as much as the payments on the working capital line of credit issued by Union Bank to ZZZZ Best in this case. In fact, the role of commercial paper, and the payments made thereon, is virtually identical in all respects to that of the line of credit in this case with the exception, perhaps, of the duration of the credit. Depletion, therefore, could not be the primary policy consideration of Congress in protecting ordinary course of business payments. Even if it were the paramount concern of the statute rather than maintaining normalized credit relations, the Ninth Circuit's rule does not better protect the estate against depletion than the rule of the Sixth Circuit that would encourage creditors to continue to deal with the debtor under their normal loan terms without threat of preference exposure, thereby providing the debtor the benefit of the loan proceeds during its period of financial distress.

IV. IF THE DISTINCTION BETWEEN LONG-TERM AND SHORT-TERM DEBT IS TO BE MADE IN APPLYING § 547(c)(2), THEN A LEGAL STANDARD MUST BE ESTABLISHED AS TO WHAT CONSTITUTES LONG-TERM DEBT, CONSISTENT WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND BUSINESS PRACTICES.

If the Court concludes that the Ninth Circuit's interpretation of § 547(c)(2) is proper, then it is nevertheless appropriate for the Court to grant this petition to determine what loans will be entitled to the protections of § 547(c)(2) and what loans will be excluded as "long term." The Ninth Circuit has not defined what constitutes "long-term" debt. The debt in *CHG Int'l* had a

term of seven months, and the loan in *ZZZZ Best* had an eight-month term. In reaching its result in *CHG Int'l*, the court relied on an opinion of the Bankruptcy Court for the Western District of Louisiana which held that a 90-day working capital loan whose maturity had been extended from time to time was a long-term debt not protected by § 547(c)(2). *CHG Int'l*, 897 F.2d at 1485, *citing In re RDC Corp.*, 88 Bankr. 97 (Bankr. W.D. La. 1988).[9]

Based on the failure of the Ninth Circuit to set forth any definition of long-term debt and its reliance on a case in which a loan of only 90 days was considered "long-term," lenders have no way of determining what loans may have a risk of preference liability in the event of a future bankruptcy filing and what term will bring the loan payments within the ordinary course of business exception. Further, the court's implicit determination that a loan of seven months or more is "long-term" is inconsistent with generally accepted accounting principles and commercial realities. Accounting standards, accepted by the Internal Revenue Service and implemented in business practice, dictate that obligations with a term of less than one year be deemed short-term, current liabilities. ARB 43; S. Stern, *supra*. The Ninth Circuit has provided no basis for using a definition of long-term debt that is different from that which has been generally accepted in the business and accounting community and which is therefore fairly within the expectation of both debtors and lenders.

[9] The ruling in *RDC* that a 90-day loan is "long-term" debt is inconsistent with the exchange between Senators DeConcini and Dole in which they confirmed that commercial paper was expressly intended to be protected by the elimination of the 45-day rule. Short-term commercial paper typically has a term of 90 days. *See New Hope Baptist*, 880 F.2d at 1175-76.

CONCLUSION

WHEREFORE, Petitioner Union Bank prays that a writ of certiorari issue from This Honorable Court to review the judgment of the Court of Appeals for the Ninth Circuit in *In re ZZZZ Best Co., Inc (Wolas v. Union Bank)*. In the event that the petition is granted, Petitioner prays that the judgment of the Court of Appeals for the Ninth Circuit be reversed and that the cause be remanded with directions to affirm the judgment of the District Court for the Central District of California.

Respectfully submitted,

JOHN ALBERT GRAHAM
Counsel of Record
LESLEY ANNE FLEETWOOD HAWES
FRANDZEL & SHARE
A Law Corporation
6500 Wilshire Boulevard
Seventeenth Floor
Los Angeles, California 90048-4920
(213) 852-1000

STEPHEN H. WEISS
Senior Vice President and
Deputy General Counsel
Office of the General Counsel
UNION BANK
445 South Figueroa Street
Los Angeles, California 90071-1602
(213) 236-5906
Attorneys for Petitioner,
Union Bank

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

No. 89-55902

IN RE ZZZZ BEST CO., INC.,
a California corporation,
Debtor.

HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ Best Co., Inc.,
Plaintiff-Appellant,

v.

UNION BANK,
Defendant-Appellee.

Appeal from the United States District Court
for the Central District of California

Argued and Submitted Dec. 4, 1990

Decided Dec. 28, 1990

Terry A. Ickowicz and Steven N. Kurtz, Wolas, Soref & Ickowicz, Los Angeles, Cal., for plaintiff-appellant.

John Graham, Frandzel & Share, Los Angeles, Cal., for defendant-appellee.

Before BROWNING, PREGERSON and LEAVY, Circuit Judges.

PER CURIAM:

ZZZZ Best entered into an eight-month revolving credit agreement with Union Bank in December 1986. It made several payments of interest and loan commitment fees

between December 1986 and July 1987, when the company filed for bankruptcy. The trustee, Wolas, tried to recover some of the payments for the benefit of the creditors as preferential transfers avoidable under 11 U.S.C. § 547. The bank defended the payments as being made in the ordinary course of business, and thus protected from recovery under § 547(c)(2). Wolas replied they were not protected because ZZZZ Best had been operating a fraudulent "Ponzi" scheme and so *had* no "ordinary" course of business. The bankruptcy court found for the bank as a matter of law, and the district court affirmed. We reverse on the authority of *In re CHG Int'l, Inc.*, 897 F.2d 1479 (9th Cir.1990), without reaching the "Ponzi" scheme issue.

In *CHG Int'l* we held that interest payments on long-term debt are not covered at all by the ordinary course of business exception. *Id.* at 1482, 1486. Union Bank argues the revolving line of credit in this case is not "long-term" because it is for less than a year; however, one of the two loans at issue in *CHG Int'l* was for only seven months, yet the court considered it long-term.

The bank also argues the revolving line of credit in this case differs from the loan at issue in *CHG Int'l* because it was pre-payable at any time and the debtor's continued access to funds depended on continuing to make interest payments. However, as a pratical matter, a debtor's continuing access to any loan depends on continuing to make interest payments—if payments are discontinued, the debtor is in default and the loan will be called. The debtor became bound when it delivered its promissory note to the bank; the exact amount of interest owed each month is irrelevant. We fail to see any significant difference between a revolving line of credit and an ordinary loan for purposes of § 547(c)(2).

REVERSED.

APPENDIX B

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CV 88-6285 KN

Bk. No. 87-13692 GM

Adv. No. 87-02472 GM

IN RE ZZZZ BEST CO., INC.,
a Nevada corporation,

Debtor.

HERBERT WOLAS, Chapter 11 Trustee,
Plaintiff and Appellant,

vs.

UNION BANK,
Defendant and Respondent.

ORDER AFFIRMING JUDGMENT

[Filed Aug. 4, 1989]

On July 31, 1989, the appeal of the Trustee, Herbert Wolas, came on regularly for hearing before the Honorable David V. Kenyon in Courtroom 3 at 9:30 a.m. Terry A. Ickowicz and Steven N. Kurtz of Wolas, Ickowicz & Soref appeared on behalf of appellant Herbert Wolas. John A. Graham of Frandzel & Share, A Law Corporation appeared on behalf of appellee Union Bank. The

Court having considered the briefs, excerpts of record and other matters submitted in connection with this appeal, and having considered the arguments of counsel, the matter having been submitted and the Court having rendered its decision in open court and good cause appearing therefor, it is

ORDERED that the judgment of the United States Bankruptcy Court is hereby *Affirmed*.

Dated: August 4, 1989

/s/ David V. Kenyon
DAVID V. KENYON
United States District Court
Judge

PROOF OF SERVICE BY MAIL

STATE OF CALIFORNIA)
) ss.
COUNTY OF LOS ANGELES)

I am a resident of the county aforesaid. I am over the age of eighteen years and not a party to the within-entitled action. I am employed by the firm of Frandzel & Share, A Law Corporation, located at 6500 Wilshire Boulevard, Seventeenth Floor, Los Angeles, California, 90048.

On August 1, 1989, I served the within ORDER AFFIRMING JUDGMENT on the interested parties in said action, by placing a true copy thereof enclosed in a sealed envelope with postage thereon fully prepaid, in the United States mail at Los Angeles, California, addressed as follows:

Terry A. Ickowicz, Esq.
Steven N. Kurtz, Esq.
WOLAS, ICKOWICZ & SOREF
1840 Century Park East, 11th Floor
Los Angeles, CA 90067

and placing the said envelope for collection and mailing on that date following this firm's ordinary business practices described above.

Executed on August 1, 1989, at Los Angeles, California.

I declare that I am employed in the office of a member of the bar of this Court at whose direction service was made.

/s/ Wilma Ginsburg
WILMA GINSBURG

APPENDIX C

UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA

Bk. No. LA 87-13692-GM

Adv. No. 87-02472-GM

(CHAPTER 11)

IN RE ZZZZ BEST CO., INC., a Nevada corporation,
Debtor.

HERBERT WOLAS, Chapter 11 Trustee,
Plaintiff,

vs.

UNION BANK,
Defendant.

JUDGMENT ON FIRST CAUSE OF ACTION; ADJUDICATION OF CONTROVERSIES ON FOURTH CLAIM FOR RELIEF [PROPOSED]

[Filed Aug. 22, 1988]

Date: Aug. 11, 1988
Time: 9:00 AM
Place: Courtroom "G"

The above-entitled cause having come on regularly for hearing before this Court on motion of defendant Union Bank for summary judgment against plaintiff Herbert

Wolas on the first claim for relief and for an adjudication of controversies on the fourth claim for relief, on June 16, 1988, the Honorable Geraldine Mund, United States Bankruptcy Judge presiding; Dana M. Perlman of Frandzel & Share appearing for Union Bank, and Terry Ickowicz of Wolas, Soref & Ickowicz appearing for plaintiff; and the Court, having reviewed the declarations and documents submitted into evidence, and having read and considered the memoranda of points and authorities submitted by the parties, and having heard and considered oral argument at the hearing, and having issued its findings of fact and conclusions of law:

IT IS ORDERED AND ADJUDGED that plaintiff take nothing on its first claim for relief, that the first claim for relief be dismissed on the merits and that defendant Union Bank recover of the plaintiff Herbert Wolas, Chapter 11 Trustee, its costs of action. A final judgment as to the first claim for relief of the complaint shall be entered forthwith in accordance with Rule 54 (b) of the Federal Rules of Civil Procedure since there is no just reason for delay.

IT IS FURTHER ORDERED that the fourth claim for relief of the complaint is limited to the assignment of collateral pursuant to 11 U.S.C. § 547(c)(5), and that § 547(c)(5) does not apply to the April 10, 1987 payment of a $2,511.38 loan commitment fee, and the $48,951.39 April 30, 1987 and the $52,869.44 June 1, 1987 payments of accrued interest.

IT IS FURTHER ORDERED that the judgment entered on July 14, 1988 is vacated.

Dated: 8/22/88

/s/ Geraldine Mund
GERALDINE MUND
United States Bankruptcy Judge

PROOF OF SERVICE BY MAIL

STATE OF CALIFORNIA)
) ss.
COUNTY OF LOS ANGELES)

I am a citizen of the United States and employed in the county aforesaid. I am over the age of eighteen years and not a party to the within-entitled action. I am employed by the firm of Frandzel & Share, A Law Corporation, located at 6500 Wilshire Boulevard, Seventeenth Floor, Los Angeles, California, 90048.

I am readily familiar with this firm's practice for collection and processing of correspondence for mailing with the United States Postal Service, and, following ordinary business practices, the correspondence is sealed and placed for collection and mailing with the United States Postal Service in Los Angeles, California, that same date.

On August 11, 1988, I served the within JUDGMENT RE FIRST CAUSE OF ACTION; ADJUDICATION OF CONTROVERSIES ON FOURTH CLAIM FOR RELIEF [PROPOSED] on the interested parties in said action, by placing a true copy thereof enclosed in a sealed envelope addressed as follows:

1) Terry Ickowicz, Esq., WOLAS SOREF and ICKOWICZ, 1840 Century Park East, 11th Floor, Los Angeles, CA 90067;

2) Davis von Wittenburg, U.S. Trustee, 3101 Federal Building, 300 North Los Angeles Street, Los Angeles, CA 90012

and placing the said envelope for collection and mailing on that date following this firm's ordinary business practices described above.

Executed on August 11, 1988, at Los Angeles, California.

I declare that I am employed in the office of a member of the bar of this Court at whose direction service was made.

/s/ Beatrice Babacci
BEATRICE BABACCI

APPENDIX D

UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA

Bk. No. LA 87-13692-GM

Adv. No. 87-02472-GM

(CHAPTER 11)

IN RE ZZZZ BEST CO., INC., a Nevada corporation,
Debtor.

HERBERT WOLAS, Chapter 11 Trustee,
Plaintiff,

vs.

UNION BANK,
Defendant.

FINDINGS OF FACT AND CONCLUSIONS OF LAW
[PROPOSED]

[Filed Aug. 22, 1988]

Date: August 11, 1988
Time: 9:00 a.m.
Place: Courtroom "G"

The above-referenced adversary proceeding came on regularly for hearing on defendant's motion for summary judgment on the first claim for relief of the complaint and for an adjudication that the fourth claim for relief is limited in scope to apply only to the assignment of collateral and on the plaintiff's cross-motion for summary judgment on June 16, 1988 at 9:00 a.m. in Courtroom "G" of the above-entitled court, the Honorable Geraldine Mund, Bankruptcy Judge presiding. Terry A. Ickowicz of Wolas, Soref & Ickowicz appeared on behalf of plaintiff Herbert Wolas, Chapter 11 Trustee. Peter Csato and Dana M. Perlman of Frandzel & Share, A Law Corporation, appeared on behalf of defendant Union Bank. The court having reviewed the Notice of Motion and Motion for Summary Judgment and for an Adjudication of Controversies on Fourth Claim for Relief, Declaration of Susan Russel in Support of Union Bank's Motion for Summary Judgment and for Adjudication of Controversies on Fourth Claim for Relief, Union Bank's Memorandum of Points and Authorities in Support of Motion for Summary Judgment and for Adjudication of Controversies on Fourth Claim for Relief, Declarations of Terry A. Ickowicz, Herbert Wolas and Donald R. Wanger, Reply and Cross-Motion for Summary Judgment and Memorandum of Points and Authorities in Support Thereof, Union Bank's Memorandum of Points and Authorities: 1. Opposition to Trustee's Cross-Motion for Summary Judgment; 2. Reply to Trustee's Response to Union Bank's Motion for Summary Judgment, Union Bank's Evidentiary Objections to the Declarations of Terry A. Ickowicz, Herbert Wolas and Donald R. Wagner, Union Bank's Supplemental Evidentiary Objections to the Declaration of Terry A. Ickowicz, and Response to Union Bank's Evidentiary Objections to the Declarations of Terry A. Ickowicz, Herbert Wolas and Donald R. Wagner, all on file in this matter and having heard the arguments and contentions of counsel, finds and concludes as follows:

FINDINGS OF FACT

1. On December 16, 1986, debtor ZZZZ Best Co., Inc. ("ZZZZ Best") and defendant Union Bank (the "Bank") entered into a revolving credit agreement ("Credit Agreement"), pursuant to which the Bank agreed to lend ZZZZ Best the sum of $7,000,000 in accordance with the terms of a promissory note to be executed and delivered by ZZZZ Best. In accordance with the custom and practice of the Bank and the custom in the commercial lending industry, the Credit Agreement provides, *inter alia*, that ZZZZ Best shall pay, on a monthly basis, a loan commitment fee of .50% per year on the average daily unused portion of the loan for the preceding month.

2. On December 17, 1987, ZZZZ Best executed and delivered to the Bank its promissory note ("Note") in the principal sum of $7,000,000. The Note provides that interest is to accrue on the principal balance at the rate of .65% per annum in excess of the Bank's reference rate and that interest shall be payable on a monthly basis.

3. In accordance with the Bank's ordinary commercial lending procedure and practice, ZZZZ Best executed on that same date an authorization for disbursement ("Authorization for Disbursement") which authorized the Bank to charge ZZZZ Best account no. 10057-9853 ("ZZZZ Best Account") for all payments due under the Note.

4. Throughout the course of the relationship between the Bank and ZZZZ Best, the Bank was a lender, providing credit to ZZZZ Best, to be used for its general working capital, at a market rate of interest. The Bank acted as a commercial lender operating under normal credit terms. The Bank did not act as an investor and had no interest or participation in ZZZZ Best's potential profits. The Bank expected to receive only the normal market interest rate on the credit which it extended to ZZZZ Best.

5. On February 2, 1987 the principal balance on the loan was paid down to $5,000,000. On February 9, 1987, the loan balance increased to $6,000,000. On February 10, 1987, the loan balance increased to $7,000,000. Pursuant to the terms of the Credit Agreement, the loan commitment fee for February, 1987 was $2,511.38.

6. Pursuant to the terms of the Credit Agreement, the Note, and the Authorization for Disbursement, the following payments were automatically deducted by the Bank from the ZZZZ Best account:

Date	Amount	Nature of Payment
December 31, 1986	$22,186.11	December 1986 Interest
February 2, 1987	$49,126.39	January 1987 Interest
March 2, 1987	$41,881.93	February 1987 Interest
March 31, 1987	$49,126.38	March 1987 Interest
April 10, 1987	$ 2,511.38	March 1987 Loan Commitment Fee
April 30, 1987	$48,951.39	April 1987 Interest
June 1, 1987	$52,869.44	May 1987 Interest

7. On July 8, 1987, ZZZZ Best filed its voluntary petition under Chapter 7 of Title 11 of the United States Code.

8. There was an ongoing business relationship between ZZZZ Best and the Bank prior to the 90 days preceding ZZZZ Best's bankruptcy.

9. At the time that the Bank and ZZZZ Best entered into the Credit Agreement, the Bank had no knowledge of any fraud allegedly perpetrated by ZZZZ Best.

CONCLUSIONS OF LAW

1. This adversary proceeding is a "core proceeding" within the meaning of 28 U.S.C. § 157.

2. Section 547(c)(2) of Chapter 11, Title 11, United States Code, provides for the exception of "ordinary course of business" transfers from the trustee's avoidance powers and this exception is not limited to just payments to "trade creditors."

3. ZZZZ Best's debt obligation to the Bank as set forth in the Note was incurred by ZZZZ Best in the ordinary course of business or financial affairs of both ZZZZ Best and the Bank. 11 U.S.C. § 547(c)(2)(A).

4. The April 10, 1987 payment of the $2,511.38 loan commitment fee by ZZZZ Best was a bargained-for element of the parties' normal financial relations and was made in the ordinary course of business or financial affairs of both ZZZZ Best and the Bank. 11 U.S.C. § 547(c)(2)(B).

5. Both the April 30, 1987 interest payment of $48,951.39 and the June 1, 1987 interest payment of $52,869.44 by ZZZZ Best were bargained-for elements of the parties' normal financial relations and were made in the ordinary course of business or financial affairs of both ZZZZ Best and the Bank. 11 U.S.C. § 547(c)(2)(B).

6. The payments of the April 10, 1987 loan commitment fee, the April 30, 1987 interest and the June 1, 1987 interest were made according to ordinary business terms and in accordance with the Bank's usual custom and practice and the terms of the Note, the Authorization for Disbursement and the Credit Agreement. 11 U.S.C. § 547(c)(2)(C).

7. The congressional intent behind 11 U.S.C. § 547(c)(2), to protect "ordinary course of business" transfers from the trustee's avoidance powers does not limit the scope of such protection only to payments to "trade creditors."

8. The congressional policy behind 11 U.S.C. § 547(c)(2) mandates the insulation of ordinary and regular payments of interest and loan commitment fees from the trustee's avoidance powers. *See, In re Smith-Douglass, Inc.*, 17 B.C.D. 769, 770 (4th Cir. 1988).

9. For the purpose of examining plaintiff's cross-motion, the Court considered the alleged facts that ZZZZ Best engaged in fraudulent business activities. Even if ZZZZ Best engaged in fraudulent business activities, ZZZZ Best's payments of interest and loan commitment fees to the Bank are excepted from the trustee's avoidance powers because the Bank was not involved in such alleged fraudulent activities and acted merely as a commercial bank lender to ZZZZ Best, and further, Union Bank was not an investor in the ZZZZ Best business.

10. The policy enunciated in the Ponzi scheme line of cases set forth below—that required equality of distribution among a defrauded class of similarly situated investors—is not applicable to this case. The Bank received the payments as a commercial lender involved in a routine loan transaction and was not an investor and had no claim to any extraordinary profits such as is the usual case in a Ponzi type scheme. *See, In Re Bishop, Baldwin, Rewald, Dillingham and Wong*, 819 F.2d 214, 217 (9th Cir. 1987); *In Re Bullion Reserve of North America*, 836 F.2d 1219 (9th Cir. 1988); *In Re Western World Funding, Inc.*, 54 Bankr. 470, 481, (Bankr. D. Nev. 1985); *In Re Independent Clearing House Co.*, 41 Bankr. 985, 1014 (Bankr. Utah 1984).

11. Judgment on the first claim for relief of the complaint should be granted in favor of defendant on the basis that the payments of interest and the loan commitment fee which plaintiff seeks to avoid as preferential payments are excepted from the trustee's avoidance powers as payments in the "ordinary course of business" pursuant to 11 U.S.C. § 547(c)(2).

12. The request to limit the scope of the fourth claim for relief of the complaint should be granted on the grounds that the Bank's improvement in condition should be limited to the assignment of collateral pursuant to 11 U.S.C. § 547(c)(5). The trustee's avoidance power under § 547(c)(5) does not apply to the April 10, 1987 payment of a $2,511.38 loan commitment fee, and the

$48,951.39 April 30, 1987 and the $52,869.44 June 1, 1987 payments of accrued interest.

13. Plaintiff's cross-motion for summary judgment should be denied in its entirety.

14. A final judgment as to the first claim for relief of the Complaint shall be entered in accordance with Rule 54(b) of the Federal Rules of Civil Procedure, since there is no just reason for delay in doing so.

All findings of fact which are additionally or alternatively conclusions of law are deemed conclusions of law; all conclusions of law which are additionally or alternatively findings of fact are deemed findings of fact.

Dated: 8/22/88

/s/ Geraldine Mund
GERALDINE MUND
United States Bankruptcy Judge

PRESENTED BY:

FRANDZEL & SHARE
A Law Corporation
JOHN A. GRAHAM
PETER CSATO
DANA M. PERLMAN

By: /s/ Dana M. Perlman
DANA M. PERLMAN
Attorneys for Defendant
UNION BANK

(2)

No. 90-1491

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

UNION BANK,
Petitioner,
v.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,
Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF IN OPPOSITION OF RESPONDENT

TERRY A. ICKOWICZ
Counsel of Record
WOLAS, SOREF & ICKOWICZ
A Professional Corporation
1801 Century Park East
Suite 1717
Los Angeles, California 90067
(213) 277-0408

HERBERT WOLAS
Chapter 7 Trustee
ZZZZ BEST CO., INC.
Attorneys for Respondent,
ZZZZ Best Co., Inc.

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

24

QUESTIONS PRESENTED

1. Did the Ninth Circuit correctly hold that transfers in connection with the revolving line of credit extended by Petitioner to ZZZZ Best Co., Inc. constituted voidable preferences on a long-term loan thereby excluding it from protection under 11 U.S.C. § 547(c)(2)?

If the Court concludes that 11 U.S.C. § 547(c)(2) protects payments on account of long-term loan obligations, then the following additional questions are presented for determination:

2. Did the Ninth Circuit err by failing to find that ZZZZ Best Co., Inc. was engaged in a ponzi scheme and, therefore, that the ordinary course of business exception found in 11 U.S.C. § 547(c)(2) does not protect the payments made to Petitioner?

3. Did the operation of a fraudulent business activity by ZZZZ Best Co., Inc. eliminate the ordinary course of business defense otherwise available to a creditor in a preference action under 11 U.S.C. § 547(c)(2)?

LIST OF PARTIES

The parties to the proceedings below were the Petitioner, Union Bank, and the Respondent, Herbert Wolas in his capacity as Chapter 7 Trustee of the bankruptcy estate of ZZZZ Best Co., Inc.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

No. 90-1491

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF IN OPPOSITION OF RESPONDENT

Herbert Wolas, the Respondent herein, prays that the writ of certiorari sought by Petitioner, Union Bank, to reverse the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on December 28, 1990, be denied.

OPINIONS BELOW

The December 28, 1990 opinion of the Court of Appeals for the Ninth Circuit reverses the judgments of the district and bankruptcy courts. The opinion is reported at 921 F.2d 968 and reprinted as Appendix A to the Petition for Writ of Certiorari (the "Petition") filed by Petitioner, Union Bank, at 1a.

On August 8, 1989, the District Court for the Central District of California entered its Order Affirming Judgment, affirming the summary judgment of the bankruptcy court granted in favor of the Petitioner, Union Bank. The district court order was appealed by the Respondent to the court of appeals. The district court order was not published and is reprinted as Appendix B to the Petition filed by Petitioner, Union Bank, at 3a.

The order of the Bankruptcy Court for the Central District of California granting summary judgment in favor of the Petitioner, from which appeal was taken by the Respondent to the district court, was not published. The bankruptcy court's Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief, entered August 23, 1988, and Findings of Fact and Conclusions of Law related thereto, are reprinted in Appendices C and D to this Petition for Writ of Certiorari filed by Petitioner, Union Bank, respectively, at 6a and 10a, respectively.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit in favor of Respondent was entered on December 28, 1990, reversing the judgments in favor of the Petitioner entered by the district court and the bankruptcy court. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED

This case involves a lawsuit filed by Respondent, a Bankruptcy Trustee, to recover from Petitioner, Union Bank, certain monthly interest payments and a monthly loan renewal fee as preferential transfers under § 547(b) of the Bankruptcy Code, Title 11 of the United States Code. Section 547(b) provides:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transaction was in insider; and
>
> (5) that enables such creditor to receive more than such creditor would have received if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Petitioner has placed reliance upon certain exceptions to the trustee's ability to avoid certain transfers under 11 U.S.C. § 547 that are set forth in § 547(c). The exception upon which the Petitioner has relied to defend against the Trustee's preference action is § 547(c)(2), which provides as follows:

> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor or transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (C) made according to ordinary business terms.

STATEMENT OF THE CASE

On November 25, 1987, the Trustee filed a Complaint against the Petitioner, Union Bank, alleging the receipt of preferential payments made to it by ZZZZ Best Co., Inc. ("ZBest") within 90 days prior to the date ZBest filed for relief under Chapter 11 of the United States Bankruptcy Code. On or about May 10, 1988, Union Bank brought its Motion for Summary Judgment and on May 23, 1988, the Trustee filed his Cross-Motion for Summary Judgment. On August 23, 1988, the Bankruptcy Court entered summary judgment in favor of Union Bank and against the Trustee and denied the Trustee's Cross-Motion for Summary Judgment.

The Trustee then filed his Notice of Appeal on August 29, 1988. After Union Bank objected to the jurisdiction of the Bankruptcy Appellate Panel, this case was referred to the United States District Court for the Central District of California.

On August 8, 1989, the District Court, the Honorable David V. Kenyon presiding, affirmed the Order of the Bankruptcy Court granting summary judgment against the Trustee and in favor of Union Bank. The Trustee timely appealed to the United States Court of Appeals for the Ninth Circuit.

The events giving rise to the making of the preferential payments by ZBest to Union Bank are relatively simple. Essentially, on or about December 14, 1986, ZBest and Union Bank entered into a Revolving Credit Agreement whereby Union Bank agreed to loan ZBest the sum of $7 Million.

To evidence the takedown of the funds, a commercial promissory note (the "Promissory Note") in the amount of $7 Million was executed on December 17, 1986. The Promissory Note indicates a maturity date of August 31, 1987. In addition, the Promissory Note required the payment of interest at the rate of not less than $500.00

per month or 0.650% per year in excess of Union Bank's reference rate, whichever was greater.

As indicated in the Promissory Note, the loan transaction by and between ZBest and Union Bank extended for a period in excess of 8½ months, which is a period in excess of the time within which standard trade credit terms are generally granted. This evidences the long-term and capital nature of the transaction with respect to the financial structure of ZBest as opposed to a transaction constituting the ordinary extension of trade credit by a general trade creditor. In addition, the substantial amount of the loan (i.e., $7 Million) is also reflective of the unusual nature of the transaction. The Promissory Note contains the following language:

> "At any time prior to maturity of this Note, the maker may borrow, repay and reborrow hereon so long as the total outstanding at any one time does not exceed the principal amount of this Note."

Reading the terms of this Promissory Note in conjunction with the language of the Revolving Credit Agreement, it becomes apparent that the transaction by and between ZBest and Union Bank was *not* an ordinary trade credit transaction, but rather, constituted an unusual transaction primarily providing for the extensive funding of ZBest's alleged restoration operations.

The alleged business operation of ZBest with respect to its restoration contracts (which constituted substantially all of ZBest's alleged gross receipts) was a fraud since the alleged restoration contracts never existed and were entirely fictitious. The continuous borrowing and repayment of funds by ZBest from investors and creditors during its fraudulent operation and prior to its filing for relief under Chapter 11 was tantamount to a fraudulent scheme designed to induce investors and/or creditors to extend credit and to repay certain investors and/or creditors in order to induce said persons to further extend larger sums of credit. In essence, the opera-

tion of ZBest, as carried out by its officers and directors, was tantamount to the classic "ponzi" scheme. The end result of the ponzi scheme was the dissipation of all funds provided by investors and/or creditors to areas and/or persons unknown, with a total resulting loss to investors acquiring shares of stock in ZBest and large losses to creditors who extended credit.

After the bankruptcy court and District found for Petitioner, the Respondent Trustee appealed the district court's ruling to the Court of Appeals for the Ninth Circuit.[1] A three-judge panel of the Ninth Circuit reversed in a *per curiam* opinion, relying on the decision of another panel of the court in *CHG Int'l, Inc. v. Barclays Bank (Matter of CHG Int'l, Inc.)*, 897 F.2d 1479 (9th Cir. 1990).

In *CHG Int'l*, the Ninth Circuit held that payments made on *long-term debt do not qualify* for the protection of the "ordinary course of business" exceptions of § 547 (c)(2) *as a matter of law*. The Ninth Circuit in the *ZBest* decision held that the eight and one-half-month revolving line of credit constitutes "long-term" debt for the purposes of § 547(c)(2) because one of the two debts in the *CHG Int'l* case had a term of seven months and was held to be long-term debt.

The ruling by the Ninth Circuit in *ZBest* does not conflict with any of the published opinions set forth by the Petitioner in the Petition inasmuch as none of the factual patterns set forth in the cases cited by Petitioner are appropriate to the case at bar. For the reasons hereinafter set forth, Respondent contends that as a matter of law, the Ninth Circuit correctly determined that the revolving line of credit constituted a long-term debt obligation of ZBest and that payments made on account of such indebtedness are not to be afforded protection under the provisions of § 547(c)(2). Specifically, the Petitioner would have this Court emasculate a long line of judicial and statutory protection provided to a debtor and creditors of the debtor's estate by having this Court determine the intent of Congress to do away with all long-standing rules regarding recovery of preference payments on long-term obligations to a lender. The Ninth Circuit *correctly* determined that the applicable exception to recovery of a preference by a trustee for the benefit of the creditors of an estate should only extend to short-term obligations and should not be a rule swallowed up by the exceptions. The Ninth Circuit *correctly* points out that the statute was not modified with the intent to extricate all banks from exposure rather, it was intended to provide assurances to trade creditors that continued financial transactions between the debtor and themselves, resulting in value to the debtor, would not be subject to attack by a trustee so long as value was equally exchanged.

[1] The Ninth Circuit's jurisdiction to hear the appeal is provided by 28 U.S.C. § 158(d) which grants the circuit courts of appeals jurisdiction to hear appeals from final decisions of the district courts entered pursuant to 28 U.S.C. § 158(a) and (b).

The Petitioner's brief falls short of the mark by failing to point out the material fact that no additional value was received by ZBest during the time in which the payments in question were made by ZBest to Petitioner. Rather, the value of all funds received by ZBest were dissipated by it during its operation of a fraudulent activity. The continued perpetration of the fraudulent activity was the direct result of ZBest maintaining the status quo on its long-term debt obligations to Petitioner to avert the Petitioner seeking legal redress resulting in an earlier collapse of its fraudulent business operation.

Furthermore, the Petitioner's Petition does not seek to instruct this Court of the facts surrounding the fraudulent activity conducted by ZBest. Specifically, the ZBest operation was not a legitimate business operation and, as the lower court noted, may not have been sufficient to

constitute a going concern such that the debt obligation incurred by it was incurred in its ordinary course of business inasmuch as ZBest may not have had the financial wherewithall to service the ZBest obligation.

The Petitioner is quick to point out that the Ninth Circuit did not define what constitutes "long-term" debt. However, this is not an appropriate statement. The Ninth Circuit defined what is not short-term debt and, specifically, determined that an eight and one-half-month revolving line of credit was tantamount to a long-term debt obligation.

Further, Petitioner points out at page 8 of the Petition that "the Court of Appeals for the Seventh Circuit has relied upon the availability of § 547(c)(2) to protect lenders from the recovery of ordinary loan payments made up to one year prior to the bankruptcy." [2]

This is an incorrect statement of the case.[3] The Seventh Circuit did not so rule, but rather, indicated, in *dicta*, that potentially, a set of examples propounded by lenders would be determined on a case by case basis and, specifically, that in the case at bar, no determination could be made. The Court's *Deprizio* decision was only to determine the liability of a guarantor. It did *not* contemplate nor rule upon a determination as to whether or not the ordinary course of business extends to long-term debt obligations. Any statement by Petitioner to the contrary is not a true reflection of the case but is merely an opinion of Petitioner based upon *dicta* set forth therein.

---

[2] See *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989), *aff'g in part and rev'g in part In re Deprizio Constr. Co.*, 86 Bankr. 545 (N.D.Ill. 1988) [hereinafter referred to as "Deprizio"].

[3] See *Barash v. Public Finance Corp.*, 658 F.2d 504 (7th Cir. 1981).

REASONS FOR DENIAL OF WRIT OF CERTIORARI

The Ninth Circuit correctly determined that the revolving line of credit constituted a long-term debt obligation and, therefore, as a result thereof, the payments made by ZBest to Petitioner, Union Bank, were not within the ordinary course of business of ZBest. In so holding, the Ninth Circuit determined that the plain Congressional intent of the statute was merely to remove an artificial time period for determining the date upon which a debt is incurred and in connection therewith, to focus attention upon the benefit to the estate of the debtor through the value received in exchange for payments made.

It is clear that the Congressional intent of the statute was not to overrule a long line of statutory and judicial history since *no* such meaning can be gleaned from the Congressional reports. Rather, what is clear is that the Congress intended to provide benefit to trade creditors which is more fully set forth at the Notes of Committee on the Judiciary, S. Rep. No. 989, 95th Cong., 2nd Sess. (1978).

In making its argument, the Petitioner attempts to have this Court set forth and define a *bright line* test as to what constitutes a long-term debt or a short-term debt obligation. Petitioner makes reference to generally accepted accounting principles but, however, fails to show their relevancy to a bankruptcy situation. Importantly, it is worth noting that the purpose of the preference provisions is to provide *equality* among creditors and to require disgorgement of amounts received by one creditor for its exclusive benefit and to the detriment of other similarly situated creditors. In such settings, it is also important to note that where a creditor provides value in exchange for the payments received, perhaps a debtor's slide into bankruptcy is minimized. Turning to the facts of the case at bar, it becomes evident that the $7 million loan by Petitioner, Union Bank, to ZBest, was

not an ordinary transaction. Rather, it was an extraordinary transaction. The funds were provided in December, 1986, seven months prior to the date upon which ZBest filed for protection from creditors. All funds provided by Petitioner, Union Bank, were dissipated by ZBest in its operation. To that extent, the payments of monthly interest accruals (which Petitioner alleges to be ordinary payments) could not possibly have provided any benefit to the estate other than to merely hold off the Petitioner from seeking to enforce its provisions of default under its loan agreements. However, Petitioner can point to *no* benefit to ZBest resulting from the payments made allegedly in ZBest's ordinary course of its business.

In addition, the Ninth Circuit did not rule upon the issue of whether or not the existence of the ZBest's fraudulent/ponzi scheme operation eliminates the availability of the ordinary course of business exception to a creditor since one engaging in such an activity cannot be said to be engaging in an "ordinary" business.

This Court should not lightly undertake the task to rewrite a statute. Respondent opines that statute writing is best left to the legislative branch which, if Petitioner believes does not correctly set forth a predominant test, should be addressed by additional legislation.

The Petitioner argues for the issuance of the writ by determining that the Ninth Circuit failed to appropriately provide a measurable standard. However, the Ninth Circuit in fact, did provide a standard both in *CHG Int'l* and in the case at bar by simply determining that an obligation of longer than six months is long-term in nature for purposes of the Bankruptcy Code.

For the reasons set forth herein, the Respondent believes that the ruling by the Ninth Circuit is not contrary to the rulings of other circuit courts and correctly maintains the integrity, purpose and scope of the preference provisions without emasculating it by supposed statutory exceptions.

I. THE *ZBEST* DECISION DOES NOT CONFLICT WITH THE DECISIONS OF OTHER CIRCUIT COURTS AND IS IN CONFORMITY WITH THE LEGISLATIVE AND JUDICIAL HISTORY OF THE STATUTE.

Petitioner, Union Bank, argues that the decision of the Ninth Circuit does not comport to the clear and plain language of the statute. Petitioner bases this argument upon amendments made to the statute in 1984 pursuant to which the 45-day limitation was deleted. Respondent opines that the decision of the Ninth Circuit is not contrary to other circuit courts who have ruled upon the propriety of § 547(c)(2) as most notable *Marathon Oil Co. v. Flatau (In re Craig Oil Co.)*, 785 F.2d 1563 (11th Cir. 1986). Specifically, in the Eleventh Circuit Court of Appeals decision, a "trade" creditor sought to avoid attack by the Chapter 11 trustee to recover payments made by a debtor as a preference under the provisions of § 547(b). As the Eleventh Circuit noted at page 1567:

> "As several courts have noted, this exception is directed primarily to ordinary trade credit transactions. These typically involve some extension of credit that are meant to be paid in full within a single billing cycle . . . Because the credit extended is meant to be extremely short term, Congress likened payment of trade credit to payment of current expenses. Recognizing that the latter had traditionally been protected from avoidance in bankruptcy, Congress insisted on the same protection to trade credit through the ordinary course of business provision . . . Since the foundation of this provision is the similarity of trade credit and current expenses rule, the scope of its protection is necessarily limited to trade credit which is 'kept current' or other trans-

actions which are paid in full within the initial billing cycle.[4]

It is interesting to note that the Eleventh Circuit in the *Marathon* decision cites *Barash v. Public Finance Corp., supra*, which coincides with the jurisdiction presiding over the *Deprizio* decision cited by Petitioner in its moving papers. In *Deprizio*, the Seventh Circuit did not overrule the *Barash* decision, nor was that decision ever discussed. More importantly, the *Deprizio* court, at page 1199 specifically states that:

> "We need not decide whether installment payments before 1984 may be recovered even though made within forty-five days of their due date, because this appeal does not present for decision the trustee's effort to recoup any particular transfer. It is enough to observe that § 547(b)(5) and (c), both *before and after amendment* exclude from recovery the bulk of ordinary commercial payments." [Emphasis Added]

As pointed out, Respondent urges this Court to note that the Seventh Circuit did not reverse the *Barash* decision which supports the finding by the Ninth Circuit in its *CHG* and *ZBest* opinion, respectively, and more so, that the *Deprizio* decision does not go directly to the merits of the case at bar. As such, the *Deprizio* decision is inappropriate for consideration in the case at bar.

---

[4] As the Eleventh Circuit pointed out in Footnote No. 8 at page 1567, 'it was for this reason that Congress originally required payment within forty-five days of incurring the obligation. This period represents a normal trade cycle.' Furthermore, Petitioner notes that there *may* also be a conflict with the Eighth Circuit based upon *Iowa Premium Serv. Co., Inc. v. First Nat'l Bank in St. Louis, etc. (In re Iowa Premium Serv. Co., Inc.)*, 695 F.2d 1109 (8th Cir. 1982). However, Petitioner's argument is misplaced since the parties thereto *stipulated* to the fact that the ordinary course of business exception applied and that the only issue was the date upon which the debt was incurred. As such, *Iowa Premium* is completely inapplicable to the case at bar.

More importantly, the Eleventh Circuit decision in *Marathon* supports the holding by he Ninth Circuit in *ZBest*.

What the Seventh Circuit, Ninth Circuit and Eleventh Circuit have recognized is that the scope and purpose of § 547(c)(2) was not changed by the mere deletion of a forty-five day artificial rule but instead, attention must be focused upon the value derived by a debtor in exchange for the payments being made. It is, of course, this presumption that enables creditors to avoid attack by a trustee seeking to recover alleged preference payments when the value received by the debtor in exchange for the payments have allowed the debtor to continue to operate its business. In the case at bar, the funds were drawn down by *ZBest* over seven months prior to its filing for protection from creditors. The continued payments of interest did not serve to enhance the business of ZBest but merely prolonged the ponzi scheme/fraudulent business by taking under its umbrella additional victims.

II. WHERE THE STATUTE IS UNCLEAR ON ITS FACE, THE INTENTION OF THE DRAFTERS SHOULD GOVERN.

In *United States v. Ron Pair Enterprises, Inc.* 489 U.S. 235, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989), this Court found the statutory language of § 506(b) to be clear on its face and, therefore, this Court enforced said provisions according to its terms. Nevertheless, this Court was quick to note, at 1031, that:

> "The plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters . . . In such cases, the intention of the drafters, rather than the strict language, controls." (Citations omitted.)

Petitioner would have this Court believe that the amendments to § 547(c)(2) in 1984, evidenced a Congressional

intent to include long-term debt within the statutory exceptions to a trustee's avoiding power. However, this Congressional intent is far from clear. As suggested by one leading commentator, the best future for § 547 (c) (2) is repeal due to the absence of "rational confining limits." See Countryman, *The Concept of a Voidable Preference In Bankruptcy*, 38 Vand.L.Rev. 713 (1985). Unless legislative intent is clearly demonstrated to *repeal* the substance of preference powers on long-term debt, this Court should be slow to reverse a long-standing rule absent clear and convincing evidence of such an intent.[5]

The judicial interpretation by the Ninth Circuit maintains the integrity of the preference powers and is reasonable and consistent with respect to long-term debt. The preferential payments made by ZBest to Petitioner did *not* provide any current benefit (value) to ZBest at the time they were made. There was merely a depletion of ZBest's estate. The proper remedy for depletion is restoration—this is best accomplished by the preference powers.

III. THE HOLDING BY THE NINTH CIRCUIT ENFORCES A LONG-STANDING POLICY THAT PAYMENTS ON LONG-TERM OBLIGATIONS SERVE NO BENEFIT TO THE DEBTOR AND MUST BE AVOIDED.

As the Petitioner correctly points out in its moving papers, two policies underlie the preference law, those being:

[5] The Sixth Circuit in *Gosch v. Burns (In re Finn)*, 909 F.2d 903 (6th Cir. 1990) discusses *Ragsdale v. Citizens and S. Nat'l Bank (In re Control Elec., Inc.)*, 91 Bankr. 1010 (Bankr.N.D.Ga. 1988) and disagreed with the general proposition that without legislative history to back it up, a change in the language of the statute is not to be respected. See also, *Waldschmidt v. Ranier (In re Fulghum Construction Corp.)*, 872 F.2d 739 (6th Cir. 1989), wherein 547(c)(2) protection was made available to repayments of "short-term" cash arvances.

1. To discourage a "race to the courthouse;" and

2. Dismemberment of the debtor during the debtor's financial decline and to equalize the distribution of assets of the estate among similarly situated creditors.

However, Petitioner's argument falls short of demonstrating why its financial arrangement with ZBest and the preferential payments it received merit consideration as being outside the scope of these two policies.

Specifically, the transaction between Union Bank and ZBest did not represent a "normally reoccurring transaction" since the $7 million loan by Union Bank to ZBest vastly exceeded any other normal credit transaction which ZBest engaged in. This large loan was utilized to enhance and in furtherance of the ZBest fraudulent business enterprise.

While Petitioner may argue that its loan should be aligned with a sale of commercial paper, it is worth noting that the seller of commercial paper (a financial institution) is making a sale of inventory in the ordinary course of its business. It is obvious that it was the debtor/seller of commercial paper that sought protection since if it was unable to sell its inventory, its slide into bankruptcy would be accomplished at a much quicker pace. However, through the redemption of commercial paper it is once again able to reenter the money market and obtain additional capital infusions for its continued operations.[6] These facts are diametrically opposed to the facts of the case at bar. Specifically, Union Bank made one (1), segregated loan to ZBest which had a matura-

[6] The Tenth Circuit decision in *Fidelity Sav. & Inv. Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989) clearly demonstrates these considerations by the Senate in discussing commercial paper redemptions. Additionally, see *CHG Int'l, supra*, in which, at fn. 11, the Ninth Circuit determined the *Fidelity* opinion to be weak, and noted that the *Fidelity* court expressly refused to decide whether it agreed with cases that hold that long-term loans are excepted from treatment as a preference.

tion date of over eight months. The policy discussed by the Senate in modifying the provisions of commercial paper sought to normalize the trade credit transactions in selling short term commercial paper. If Congress had intended to totally emasculate the preference provisions, then Congress should have specifically stated that the exception provided by § 547(c)(2) is not limited to normal trade credit transactions but rather, encompasses all transactions between a debtor and *any* creditor. Congress did not intend and this Court should be leery of rewriting a statute which has a long history of judicial decisions which Congress did not expressly intend to overrule.

IV. THE NINTH CIRCUIT, RELYING ON *CHG INT'L, INC.*, PROPERLY DETERMINED THAT PREFERENTIAL PAYMENTS UPON A LONG-TERM DEBT INSTRUMENT ARE OUTSIDE THE SCOPE OF THE PROTECTION AFFORDED BY § 547(c)(2).

In its *CHG Int'l* decision, the Ninth Circuit *correctly* pointed out that § 547(c)(2) "was intended to complement the contemporaneous exchange section," at 1483. In so finding, the Ninth Circuit relied upon the Seventh Circuit decision in *Barash.*[7] Moreov r, the Ninth Circuit, at 1483, correctly pointed out that:

> "The rationale for both the old 'current expense' rule and for § 547(c)(2) exception is the same: the payment does not diminish the estate, is not for an antecedent debt, and allows the debtor to remain in business."

In the case at bar, the preferential transfers from ZBest to Petitioner, Union Bank:

(1) Dimished the estate;

(2) Were on account of an antecedent debt; and

[7] See also *Matter of Xonics Imaging Inc.*, 837 F.2d 763, 766 (7th Cir. 1988).

(3) Did nothing to allow ZBest to remain in business.

Respondent urges this Court to recognize, as did the Ninth Circuit in *CHG Int'l*, that the better view is that Congress did *not* intend to fundamentally change the preference avoiding powers but rather, to only eliminate an artificial time limit.

V. THE ORDINARY COURSE OF BUSINESS EXCEPTION IS INAPPLICABLE TO A CREDITOR WHEREIN THE DEBTOR HAS ENGAGED IN A PONZI/FRAUDULANT BUSINESS SCHEME.

As argued in the lower court, but not decided by the Ninth Circuit in the *ZBest* decision, a line of cases has developed which holds that a debtor who engages in a ponzi/fraudulent business enterprise cannot be deemed to be operating an ordinary business and, therefore, creditors are unable to rely upon the ordinary course of business exception provided by § 547(c)(2) to avoid a preference attack by a trustee. See *Danning v. Bozek (In re Bullion Reserve of North America)*, 836 F.2d 1214 (9th Cir. 1988), *Graulty v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.)*, 819 F.2d 214 (9th Cir. 1987).

While the Ninth Circuit did not reach this issue (as a result of its determination that the obligation owed by ZBest to Union Bank was a long-term debt obligation), if this Court should determine that the arguments of Petitioner have merit, then this Court must address the subsidiary issue which the Ninth Circuit failed to address. As aptly stated by the Ninth Circuit in *Bullion Reserve* and *Graulty*, respectively, the protection afforded under § 547(c)(2) was not intended to protect one victim of the debtor's fraud at the expense of others. Where a debtor engages in activities which are tantamount to a ponzi scheme/fraudulent business enterprise the debtor may not be said to be operating a legitimate

trade or business and, therefore, no transaction can be considered "ordinary."

CONCLUSION

WHEREFORE, Respondent, Herbert Wolas, prays that a writ of certiorari sought by Petitioner from this Honorable Court to review the judgment of the United States Court of Appeals for the Ninth Circuit for In re ZZZZ Best Co., Inc. be denied. Respondent requests that the judgment of the Court of Appeals for the Ninth Circuit be sustained.

Respectfully submitted,

TERRY A. ICKOWICZ
Counsel of Record
WOLAS, SOREF & ICKOWICZ
A Professional Corporation
1801 Century Park East
Suite 1717
Los Angeles, California 90067
(213) 277-0408

HERBERT WOLAS
Chapter 7 Trustee
ZZZZ BEST CO., INC.

Attorneys for Respondent,
ZZZZ Best Co., Inc.

3

No. 90-1491

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

UNION BANK,
Petitioner,

vs.

HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ BEST CO., INC.,
Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF CALIFORNIA BANKERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

MASON C. BROWN
Counsel of Record
ROBERT L. MORRISON
KENNETH N. RUSSAK

PILLSBURY, MADISON & SUTRO

725 South Figueroa Street, Suite 1200
Los Angeles, California 90017
(213) 488-7100

Attorneys for Amicus Curiae
CALIFORNIA BANKERS ASSOCIATION

Lawyers Brief Service / Legal Printers / (213) 383-4457 / (714) 720-1510

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1990

UNION BANK
Petitioner,

v.

HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ BEST CO., INC.
Respondent.

PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

The California Bankers Association ("CBA") hereby respectfully moves for leave to file the attached brief *amicus curiae* in this case. The consent of the attorney for the Petitioner has been obtained. The consent of the attorney for the Respondent has been requested but denied.

The CBA, organized as a California nonprofit corporation, is a trade association with over 450 members. CBA's members include virtually every commercial bank in California.

The members of the CBA have a significant stake in the outcome of this case. The effect of the opinion issued below by the United States Court of Appeals for the Ninth Circuit, if not reversed by this Court, would be to eliminate for long-term commercial lenders--and perhaps all commercial lenders--an important defense to bankruptcy preference actions: the so-called "ordinary course of business" exception. 11 U.S.C.§ 547(c)(2)(1979 & Supp. 1991). This exception was first extended to long term lenders by Congress in the Bankruptcy Amendments and Federal Judgeship Act of 1984 when a 45-day limitation on the exception was deleted from the Bankruptcy Code. Since then, the Sixth Circuit has held that the exception is available to creditors under long term consumer instruments, *Gosch v. Burns (In re Finn)*, 909 F.2d 903 (6th Cir. 1990), and the Tenth Circuit has held that the exception is also, at a minimum, available to commercial creditors holding savings certificates which had maturities of up to one year (reserving determination as to whether the exception may be employed by creditors under longer term instruments), *Fidelity Sav. & Invest. Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989). Moreover, the Seventh Circuit based its controversial *Deprizio* decision in part on an assessment that the "ordinary course of business" exception to a preference action is available to long term commercial lenders. *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Co.)*, 874 F.2d 1186 (7th Cir. 1989). Only the Ninth Circuit, the jurisdiction in which CBA members are based, and perhaps the Eleventh Circuit, *Marathon Oil Co. v. Flatau (In re Craig Oil Co.)*, 785 F.2d 1563, 1567 (11th Cir. 1986), have construed the exception to exclude apparently all commercial loans as a matter of law.

The CBA can present a unique perspective on the effect this patchwork quilt of decisions will have on its members, the banking industry and the economy in general. The Petitioner's brief mentions these concerns, but does not fully address the factual, statistical and legislative events germane to the broader industry and national interests at stake. The proposed brief *amicus curiae* examines the importance of the questions presented by the Petitioner in light of issues now receiving intense scrutiny by other branches of the federal government, as well as industry. In part, the attached proposed brief addresses:

(1) The "credit crunch" effect the Ninth Circuit rule will have on credit availability to weakened but viable borrowers;

(2) A projected percentage of loans potentially affected by the Ninth Circuit rule and the impact of the potential liability on banks already challenged by increased credit risks; and

(3) The impact the split in the circuits could have on efforts to improve the efficiency of interstate banking and branching.

Moreover, the Petitioner's brief does not address the Ninth Circuit's apparent exclusion of *all* bank loans from the ordinary course of business exception, not just long term bank loans.

The Petitioner in this case, Union Bank, is a member of the CBA and its Petition for Writ of Certiorari has focused the Court on many important issues raised by the opinion below. The CBA,

however, has a broader industry perspective which the CBA believes will assist this Court in its determination whether to grant certiorari.

Dated: April 23, 1991

Respectfully submitted,

Mason C. Brown

Mason C. Brown
Counsel of Record
Robert L. Morrison
Kenneth N. Russak
PILLSBURY, MADISON & SUTRO

Counsel for *Amicus Curiae*
California Bankers Association

TABLE OF CONTENTS

APPENDIX

TABLE OF AUTHORITIES

Page(s)

Cases

Billings v. Zions First Nat'l Bank, (In re Granada, Inc.), 110 Bankr. 548 (Bankr. D. Utah 1990) 10

Cambridge Meridian Group, Inc. v. Connecticut Nat'l Bank (In re Erin Food Services, Inc.), 117 Bankr. 21 (Bankr. D. Mass. 1990) 10

CHG Int'l., Inc. v. Barclays Bank (In re of CHG Int'l, Inc.), 897 F.2d 1479 (9th Cir. 1990) 2, 5

Coral Petroleum Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir. 1986) 11, 12

Fidelity Sav. & Invest. Co. v. New Hope Baptist, 880 F.2d 1172 (10th Cir. 1989) 5, 6

Gosch v. Burns (In re Finn), 909 F.2d 903 (6th Cir. 1990) 5, 6

In re Installation Services, Inc., 101 Bankr. 282 (Bankr. N.D. Ala. 1989) 10

Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Co.), 874 F.2d 1186 (7th Cir. 1989) 5-7, 10, 11

Statutes

Other Authorities

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1990

UNION BANK
Petitioner,

v.

HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ BEST CO., INC.
Respondent.

PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF OF CALIFORNIA BANKERS ASSOCIATION AS
AMICUS CURIAE IN SUPPORT OF PETITIONERS

Mason C. Brown
Counsel of Record
Robert L. Morrison
Kenneth N. Russak
PILLSBURY, MADISON
& SUTRO
725 South Figueroa Street
Suite 1200
Los Angeles, California 90017
(213) 488-7100

Attorneys for California
Bankers Association
as *Amicus Curiae*

INTERESTS OF *AMICUS CURIAE*

The California Bankers Association ("CBA"), organized as a California nonprofit corporation, is a trade association with over 450 members. CBA's members include virtually every commercial bank in California.

The members of the CBA have a significant stake in the outcome of this case. The Ninth Circuit's elimination of the ordinary course of business exception to preference actions for long term loans, and perhaps all bank loans, will adversely affect CBA members. Unless the Ninth Circuit is reversed, CBA members will not be able to defend against bankruptcy preference actions by proving that they dealt with their borrowers on ordinary business terms during the borrowers' unfortunately unsuccessful efforts to avoid bankruptcy. Instead, California banks, and other financial institutions in jurisdictions following the Ninth Circuit, will be given a strong incentive by the Bankruptcy Code to redeploy their loan funds from apparently weakened borrowers to stronger customers. This will significantly limit the ability of banks to work constructively with their troubled borrowers.

SUMMARY OF ARGUMENT

The questions presented by Union Bank's petition are matters of significant national importance. As Union Bank well demonstrates in its Petition for Writ of Certiorari, the decision below not only conflicts with the decisions of three other Circuit Courts of Appeal, it violates principles of statutory construction well established by this Court.

The error below will adversely affect the vast majority of bank loans--perhaps all bank loans--which became the subject of bankruptcy preference actions. The practical consequences of the error will be to increase the loan losses of commercial banks and to tighten credit for their borrowers at the very time at which the federal government and the banking industry are working hard both to make banks safer and to increase the ability of banks to work with their viable, but weakened customers. Moreover, the conflict in the circuits will work at cross purposes with efforts now underway to improve the efficiency and feasibility of interstate banking and branching.

These adverse practical consequences highlight the reasons advanced by Union Bank for granting its petition for writ of certiorari.

ARGUMENT

1. Introduction: The National Context

The decisions of the Ninth Circuit in the case below[1] and its progenitor, *CHG Int'l., Inc. v. Barclays Bank (In re CHG Int'l, Inc.)*, 897 F.2d 1479 (9th Cir. 1990), have come at a time in which the President of the United States,[2] Congress,[3] the Department of the

[1] *Wolas v. Union Bank (In re ZZZZ Best Co.)* 921 F.2d 968 (9th Cir. 1990).

[2] In his State of the Union Address on January 29, 1991, President George Bush announced a proposal for "[a] banking reform plan to bring America's financial system into the 21st century -- so that our banks remain safe and secure and can continue to make job-creating loans for our factories, business and home-buyers. I do think there has been too much pessimism. Sound banks should be making more sound loans, now." 137 Cong.

Treasury,[4] the Federal Deposit Insurance Corporation,[5] the Federal Reserve and other federal agencies,[6] as well as private business associations[7] and writers[8] are focusing on two related problems confronting the national banking industry and federal bank insurance funds. On the one hand, recent experience with the thrift industry and a recessionary economy have led to an environment in which banks, reacting in part to what most characterize as "excessive" regulatory criticism,[9] have significantly

Rec. S1217 (daily ed. Jan. 29, 1991) (State of the Union Address by President Bush).

[3] Title X of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183, 507-11 (1989) ("FIRREA"), directed various federal agencies to prepare studies of, *inter alia*, federal deposit insurance programs and national banking services.

[4] Pursuant to Title X of FIRREA, *supra* note 3, on February 14, 1991, the U.S. Treasury Department issued its report. *Modernizing the Financial System, U.S. Treasury Department Recommendations for Safer, More Competitive Banks*, Fed. Banking L. Rep. (CCH) No. 1377, Pt. II (Feb. 14, 1991) (hereinafter *Recommendations*).

[5] *See* FDIC, *The FDIC Quarterly Banking Profile*, Fourth Quarter 1990 (1990).

[6] *E.g.*, *Regulators Issue Joint Supervisory Policies*, OCC, FDIC, FRB, OTS Joint Agency News Release (March 1, 1991); Office of the Comptroller of the Currency, *Operations of National Banks*, Quarterly Journal, Vol. 9, No. 4 at 1 (1990) (hereinafter *Operations of National Banks)*.

[7] *Credit Crunch: Federal Bank Examination at Cross Purposes*, RTC Rep., Feb 11, 1991.

[8] *E.g.*, *A Message to the Money Men*, U.S. News and World Rep., Apr. 8, 1991 at 70; *The Credit Crunch Is Latest Harsh Blow For Smaller Retailers*, Wall St. J., Apr. 9, 1991, at 1, col. 1.

[9] Michael Boskin, Chairman of President Bush's Council of Economic Advisors, told members of the Senate Budget Committee on February 6, 1991, that "[t]here is enormous evidence that regulation [has] swung too far to the other side." *Brady Says Government May Issue Package to Deal with Credit Crunch in 10*

tightened credit policies. Many, including the President of the United States, have concluded that credit is now too tight, thereby restricting economic growth. The fear, of course, is that well intentioned efforts to improve the capital base of banks and the credit quality of their loan portfolios will exacerbate the current recession and handicap the economy during and after economic recovery.[10]

On the other hand, federal authorities and private analysts have recognized that banks are currently facing greater credit risks than they have in decades. Adding to the problem is an antiquated system of regional banks, fettered from full utilization of existing and developing interstate banking opportunities by statutory and regulatory constraints. Accordingly, although most recognize that the banking

Days, 56 BNA's Banking Rep. (BNA), at 224 (Feb. 11, 1991). Additionally, in a statement accompanying policy guidelines recently issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corp., the Federal Reserve Board, and the Office of Thrift Supervision, the four regulators wrote that some depository institutions may have become overly cautions in their lending practices because of recent credit problems in various sectors of the economy and that "[i]n some instances this caution has been attributed to concerns on the part of lenders that the regulators of depository institutions are applying excessively rigorous examinations standards." *Regulators Release Joint Policy Statement on Various Regulatory, Accounting Issues*, 56 BNA's Banking Rep. (BNA), 394-95 (March 4, 1991). *See also Greenspan Expects Proposals Aimed at Easing Credit Crunch*, Reuters Bus. Rep. (Feb. 20, 1991).

[10] *Bush Reviews Economy, 'Credit Crunch' With Top Advisors, including Greenspan*, 56 BNA's Banking Rep. (BNA), at 124 (Jan. 21, 1991).

industry is fundamentally sound,[11] many are now focusing their efforts on making the industry safer, modernized and more competitive.[12]

The Ninth Circuit's recent rulings (in stark conflict with the positions of three other circuits[13]) that long term lenders cannot enjoy the protection of an important defense against bankruptcy preference actions should be viewed in this context.[14] Indeed, the *ZZZZ Best* decision appears to take the *CHG* holding one step further and, by excluding revolving lines of credit, excludes virtually all commercial loans from the defense.

In *CHG*, the Ninth Circuit held, as a matter of law, that payments on account of long term debt could not be protected by the "ordinary course of business" exception to preference actions provided by 11 U.S.C. § 547(c)(2)(1979 & Supp. 1991). In *ZZZZ Best*, the Ninth Circuit held that even revolving lines of credit are unprotected by the exception. *In re ZZZZ Best*, 921 F.2d at 969 ("We fail to see any significant difference between a revolving line of credit and an ordinary loan for purposes of § 547(c)(2)."). Thus, in the Ninth Circuit's view, the ordinary course of

[11] Board of Governors of the Federal Reserve System, *Monetary Policy Report to Congress* 77 Fed. Res. Bull. 147, 163 (1991) (hereinafter *Report*).

[12] *E.g.*, *Recommendations*, *supra*, note 4.

[13] *Gosch v. Burns (In re Finn)*, 909 F.2d 903 (6th Cir. 1990); *Fidelity Sav. & Invest. Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989); *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Co.)*, 874 F.2d 1186 (7th Cir. 1989).

[14] The CBA will not at this juncture address the merits of the decision below in any detail. Suffice it to say that the CBA generally joins in petitioner's view of the merits of the Ninth Circuit's interpretation of the exception.

business exception affords no protection even to regular, timely payments of interest on a bank revolving line of credit made when the debtor is or could be making additional draws under the line of credit. If, for example, a debtor were to have made an ordinary principal draw on a revolving bank line of credit and then to have made an ordinary payment on the line to the bank, both shortly before bankruptcy, the Ninth Circuit would apparently hold that the exception is not available to the bank. In essence, the Ninth Circuit may have excluded virtually all commercial bank loans from the exception.

Respondent's brief in opposition to the Petition argues that there is no conflict in the circuits. Brief in Opposition of Respondent (hereinafter Respondent's Brief) 11-13. Respondent's Brief, however, fails to discuss the Sixth Circuit's holding in *In re Finn* that "transfers made pursuant to long-term debt [can] be excepted from the avoidance provisions of § 547(b)" under the ordinary course of business exception of § 547(c)(2). *In re Finn*, 909 F.2d at 908. Respondent's discussion of the conflict question likewise ignores the Tenth Circuit's holding in *Fidelity* that obligations with terms of up to one year can enjoy the benefit of the exception. *Fidelity*, 880 F.2d at 1176-77. These decisions starkly conflict with the holdings of the Ninth Circuit that obligations with maturities as short as seven months are not covered by the exception. *In re ZZZZ Best*, 921 F.2d at 969.

Moreover, Respondent casually dismisses as *dicta* the position adopted by the *Deprizio* court that payments on long term debt can be covered by § 547(c)(2). Respondent's Brief 8. Although the rationale of the *Deprizio* decision is complex, the Seventh Circuit's analysis of the applicability of the

ordinary course of business exception played a significant role in its decision. The Court there held that equitable or policy considerations could not defeat the Trustee's position at least in part because long term lenders were protected by § 547(c)(2). *In re Deprizio*, 874 F.2d at 1200 ("In light of these exclusions, there is no reason to use ambulatory arguments of 'equity' or 'policy' to defeat the Trustee's claims in this case."). In the Ninth Circuit, there can be no such reliance.

Whether or not the *Deprizio* court's analysis of the exception was *dicta*, Respondent's Brief only highlights the depth of the conflict in the circuits by suggesting that the Eleventh Circuit has developed a position consistent with the Ninth Circuit rule that the § 547(c)(2) exception "is directed primarily to ordinary trade credit transactions." *Marathon Oil Co. v. Flatau (In re Craig Oil Co.)*, 785 F.2d 1563, 1567. (11th Cir. 1986).

As set forth in more detail below, the net effect limiting the exception to short term trade debt, if not excluding virtually all commercial loans from the exception, will be to tighten credit and to increase loan losses suffered by banks (and other commercial lenders). Moreover, the conflict in the Circuits will needlessly complicate efforts to facilitate existing and developing interstate banking opportunities, as well as to improve the efficiency and competitiveness of our national banking system.

2. Magnitude of the Problem.

The questions presented by Petitioner are issues of significant magnitude both to California banks and to the lending community nationwide. At a minimum,

the Ninth Circuit has clearly excluded long terms loans--if not all bank loans--from protection under § 547(c)(2). Moreover, the Ninth Circuit has adopted a very restrictive definition of short term debt, holding that loans with maturities as short as seven months are not "short term loans." *In re ZZZZ Best*, 921 F.2d at 969.

The percentage of loans potentially affected by these rules is significant.[15] According to data obtained from the Federal Deposit Insurance Corporation's database of Bank Call Reports, commercial banks reported $1.014 trillion of fixed rate[16] loans

---

[15] There are no data which can support a meaningful estimation of the actual dollar volume of loans potentially affected by the Ninth Circuit rule, in part because no statistics are kept which identify borrowers which are likely to file bankruptcy petitions and in part because no statistics are maintained which compile the number of preference actions filed or threatened in pending bankruptcy cases. Moreover, the nature of the ordinary course of business exception makes it more difficult to identify payments at risk under the Ninth Circuit rule because the exception is by definition primarily available only to creditors which receive payments in an ordinary, regular, timely fashion. (Some courts do, however, recognize that a well established pattern of late payments can also be "ordinary" within the meaning of the exception, if other tests are met.) While a lender could conceivably be alerted to preference risks for borrowers making irregular, late payments, the problem in identifying the risk for current, performing loans is significant, and emphasizes the risk and unfairness of the Ninth Circuit rule.

[16] The FDIC records maturity distribution data for variable rate loans as well, but the data is not meaningful for instant purposes, because the maturity distribution of variable rate loans is based upon the time between interest rate adjustments, not the date the loan matures. (The data is maintained primarily to analyze interest rate sensitivity of bank loan portfolios.) Accordingly, a loan due in 30 years with an interest rate adjustable every month would be classified as a loan with a maturity of from zero to three months.

outstanding as of December 31, 1990, with remaining maturities distributed as shown on Table 1 of the attached Appendix. In sum, loans with maturities of one year or less comprised only 34.54 percent, or $350.1 billion of the $1.014 trillion in outstanding fixed rate loans, with the remaining 65.46 percent, or $663.5 billion of the loans, having maturities of over one year.

The data for California banks are quite similar. As of December 30, 1990, the major California domestic banks and California regional banks which provided data to an independent bank analyst ("Reporting California Banks") reported that, excluding loans with maturities of 24 hours or less, fully 76%, or $73.1 billion, of the $96.2 billion in loans outstanding on December 31, 1990 had remaining maturities in excess of one year.[17]

Indeed, the magnitude of the problem is even greater if, as appears to be the Ninth Circuit's view, a "short term" loan is something significantly less than a seven month loan. On a nationwide basis, at least 79.73 percent, or $808.2 billion, of the fixed rate commercial bank loans at December 31, 1990 had remaining maturities of more than three months, with only 20.27 percent, or $205.4 billion with maturities of three months or less. For the reporting California Banks, 83.34 percent, or $80.2 billion, of the loans at December 31, 1990, had maturities greater than three months, with only 16.66%, or $16 billion of the loans with maturities between 1 day and three months.

Nonetheless, for the sake of completeness, the data are presented in Table 3 of the attached appendix.

[17] *1991 Findley Reports on California Banks*, §§ 2, 3. (See Table 2 of Appendix).

Inasmuch as the distribution of loan maturities to pre-petition debtors most likely reflects the distribution of loan maturities generally, one can safely conclude that the vast majority of loans by commercial banks would adversely be affected in circuits adopting the Ninth Circuit rule. Indeed, on a national basis, the Ninth Circuit's rule would at a minimum deny the availability of the "ordinary course of business" exception to approximately 65 to 80 percent of all loans presently outstanding from commercial banks. In California, the impact would be even greater, with the range of long term loans comprising about 75 to 83 percent of all loans.[18]

This problem is compounded by the controversial indirect preference rule, commonly referred to as the *Deprizio* rule, followed by the Sixth Circuit, *Ray v. City Bank & Trust Co. (In re C-L Cartage Co.)*, 899 F.2d 1490, 1492 (6th Cir. 1990), the Seventh Circuit, *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Co.*, 874 F.2d 1186 (7th Cir. 1989) and the Tenth Circuit, *Manufacturers Hanover Leasing Corp. v. Lowrey (In re Robinson Bros. Drilling, Inc.), 892 F.2d 850 (10th Cir. 1989)* and some lower courts, *Cambridge Meridian Group, Inc. v. Connecticut Nat'l Bank (In re Erin Food Services, Inc.)*, 117 Bankr. 21, 29 (Bankr. D. Mass. 1990), *Billings v. Zions First Nat'l Bank, (In re Granada, Inc.)*, 110 Bankr. 548, 549-50 (Bankr. D. Utah 1990); *In re Installation Services, Inc.*, 101 Bankr. 282, 284 (Bankr. N.D. Ala. 1989).

In those cases, the courts held that the preference period can be as long as one year if the

[18] This figure excludes loans with maturities of 24 hours or less.

lender holds the guarantee of an insider of the debtor.[19] If the *Deprizio* rule remains good law and if the ordinary course of business exception is not available to long term lenders, the magnitude of the problem could be enormous. Banks receiving regular, timely payments on debts guaranteed by insiders could be required to defend against preference actions seeking recovery of up to one year's payments. Left to defending against the *prima facie* case, banks will be at the whim of fact finders dealing with such difficult issues as the borrower's solvency at the time of payment and whether the payment enabled the creditor (or, perhaps, the insider) to obtain more than it would have obtained in a liquidation.

3. The Ninth Circuit Rule Will Give Banks an Incentive To Tighten Credit To Existing and New Borrowers.

The ordinary course of business exception was created to buttress one of the primary purposes of the preference statute: to give creditors an incentive to deal with debtors on ordinary business terms during periods of financial difficulty. *See Coral Petroleum Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1355 (5th Cir. 1986); 4 Collier on Bankruptcy ¶ 547.01 at 547-11 (15th Ed. 1991). By penalizing aggressive creditor action and rewarding cooperative behavior, the exception helps reduce the number of bankruptcies because borrowers are granted access to the capital, goods and services needed to earn their way out of financial difficulty. House Comm. on the Judiciary,

[19] The *Deprizio* court based its holding, in part, on an assessment that the ordinary course of business exception was available to lenders. *Deprizio*, 874 F.2d at 1200.

Bankruptcy Reform Act of 1978, H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6138 ("The protection thus afforded the debtor [by the preference section] often enables him to work his way out of a difficult financial situation through cooperation with all his creditors."). *See also Coral Petroleum*, 797 F.2d at 1355 (quoting House Report); 4 Collier on Bankruptcy ¶ 547.01 at 547-11 (15th Ed. 1991).

The exception thus has special relevance in relationships in which the customer may have suffered a down-turn, but appears to be at least marginally viable. If lenders and other creditors continue dealing with a troubled customer on ordinary business terms, the customer's efforts to earn its way out of trouble often succeed and the policy of the ordinary course of business exception is vindicated.

Sometimes, however, despite creditor cooperation and ordinary course dealings, a bankruptcy filing follows within the 90 days after the creditor receives ordinary course payments (or within one year if the bank holds an insider's guarantee) and the debtor, or its trustee, attempts to recover the payments for the benefit of the estate.

The ordinary course of business exception protects the creditor under these circumstances. Because neither the creditor nor the debtor engaged in any unusual action during the debtor's slide into bankruptcy, the creditor is allowed to retain the otherwise preferential payments.

This safe haven is granted because many times the creditor is correct in its assessment that its borrower, although weakened, is viable. If in such

cases a creditor were nonetheless to call a loan or to refuse to extend further credit, a modest retrenchment could turn into a full-scale slide into insolvency. Rather than avoiding bankruptcy, bankruptcy is the result. *See In re Sunup/Sundown, Inc.*, 66 Bankr. 1021, 1022 (Bankr. S.D. Fla 1986) ("The preference section of the bankruptcy code was developed to discourage unusual business delays between the debtor and his creditors while the debtor is financially unstable and close to bankruptcy.").

The ordinary course of business exception thus gives the bank an incentive to continue its relationship with its existing but troubled borrowers, so long as the credit and payment relationship is conducted according to ordinary business terms. That way, the bank is not forced to bear the risk that its assessment of the debtor's viability is incorrect. When the bank is correct, the bankruptcy courts are not involved. When the bank is incorrect, the ordinary course of business exception protects the bank's good efforts nonetheless.

In the absence of an ordinary course of business exception, a bank confronted with an apparently weakened borrower might conduct itself entirely differently. Given the possibility that it might have to disgorge up to one year's timely payments, it might well elect not to rely on its assessment that the borrower is viable. The rational bank might well elect to terminate its relationship and direct its limited resources to other apparently stronger customers. Cut-off from an important source of credit, the once viable customer becomes moribund.

This result is at least as likely for long term bank credit facilities as with other credit relationships. In this era of limited credit availability, a bank left

unprotected by the ordinary course of business exception would have strong reason to call loans from its marginally viable, yet fully performing borrowers and to redeploy those loan funds to healthier customers.

Such strategies, rationally driven by the Ninth Circuit rule, would only exacerbate the "credit crunch" plaguing our economy at the very time in which the federal government and industry are working to free up credit to credit-worthy and, perhaps more importantly, troubled borrowers.[20]

In their March 1, 1991, news release and accompanying policy statement, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board and the Office of Thrift Supervision discussed the factors causing banks to restrict credit and focused on the need to have banks work with weakened borrowers, not abandon them:

> Recent concerns related to a tightening of credit have focused the agencies' attention on regulatory policies and their effects on institutions' willingness to extend new credit and to work with troubled borrowers.
>
> * * *
>
> Depository institutions have traditionally worked with their borrowers who are experiencing problems. In the current economic environment, it is especially important for institutions to avoid shutting off credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems.
>
> Consistent with sound banking practices, depository institutions, including those with low capital positions, should work in an appropriate and constructive fashion with borrowers who may be experiencing temporary difficulties.

General Statement, OCC, FDIC, FRB, OTS Joint Agency News Release 2-3 (March 1, 1991).

The Ninth Circuit's rule works at cross purposes with the efforts of the these agencies to ease the credit crunch by creating an incentive for banks to reduce their lending to their existing weak, but viable borrowers, rather than working with those borrowers "in a constructive fashion." Excluding banks from the ordinary course of business exception will decrease the willingness of banks to work with borrowers who are weakened, but making regular timely payments on their loans. The Ninth Circuit's rule will thus only add to the problem of banks being forced by regulatory

[20] *See, e.g.,Fed May Ease Rates Again If Credit Crunch Does Not Abate, Greenspan Says*, 56 BNA's Banking Rep. (BNA) 16 (Jan. 28, 1991) ("We are looking at other ways to restore a modicum of rational lending when we are dealing with credit-worthy customers. . . We are looking at other strategies to confront the credit crunch. We are pressing this issue as readily as we can."), *U.S. Seeks to Curb Recession by Focusing on the 'Credit Crunch'*, Wall St. J., Feb. 4, 1991, at 1, col. 6 ("[T]he 'credit crunch' has become Public Enemy No. 1 here at home.").

pressure to call loans even from borrowers who are fully and timely performing all loan obligations.

4. The Increased Risk Imposed by the Ninth Circuit Rule Threatens an Already Challenged Banking Industry With Increased Loan Losses.

Most observers agree that banks today are simply in no position to absorb the additional liability that will result from the Ninth Circuit rule. As the FDIC reported to Congress on February 20, 1991, "banks by and large are sound and well capitalized, but concerns about the strength of the industry intensified throughout 1990.[21]

Accordingly, the General Accounting Office and the Congressional Budget Office have each issued reports questioning the financial health of large banks and exploring the implications for the Bank Insurance Fund.[22]

The FDIC's most recent Quarterly Banking Profile reports that during the fourth quarter, 1990, banks reported the lowest quarterly income since the banking industry began reporting quarterly income in 1983, an amount which represented a 50% decline from the fourth quarter, 1989. The FDIC explained the results as follows:

> Higher levels of troubled assets and increased provisions for future losses

[21] *Report, supra*, note 11 at 163. *See also, U.S. Banks: A Crisis in the Making?* Los Angeles Times, Sunday Apr. 14, 1991, at A1, c1. FDIC Report, *supra*, 77 Fed.Res.Bull. 163.

[22] Report, *supra* note 11, at *id.*

> were the determining factors in banks' poor fourth quarter results. The $11 billion that banks set aside for future domestic credit losses was the highest quarterly amount ever; the previous record was $7.8 billion for the third quarter, 1990. For the full year, total provisions for losses on domestic and foreign operations were $31.7 billion, $670 million more than in 1989. Troubled assets totalled 2.9 percent of all bank assets at the end of 1990. Total assets increased by $5.7 billion in the fourth Quarter but interest-earning assets *fell* by $14.7 billion. . . . The 2.7 percent growth rate for total banking assets in 1990 was the lowest since the 2.0 percent in 1987. For the second consecutive quarter, the proportion of total assets represented by non-current loans and foreclosed real estate set an all time record.

FDIC, *supra* note 5, at 1-2. *See also Operations of National Banks*, *supra* note 6, at p.1.

The ordinary course of business exception would significantly reduce loan losses of national banks if it were interpreted to cover ordinary, timely payments made on account of long-term loans, not to mention short term revolving lines of credit. Again, a precise quantification of the preference loss exposure is impossible but, as discussed above, the magnitude of the risk is significant.

On the merits, this Court might conclude that the Ninth Circuit correctly held that it should ignore

the unambiguous language of the statute and exclude long term and other bank debt from the protections of the § 547(c)(2) exception. The CBA believes the Ninth Circuit erred and urges this Court to accept review and, when the matter is decided on the merits, to reverse. The important point at this juncture is that, however this Court rules, the ruling will have a significant impact on the loan losses suffered by long term lenders at a time when the banking industry is already challenged by a large number of problem loans.

5. **The Conflicting Sets of Rules Threatened by the Ninth Circuit's Stance Will Work at Cross Purposes With Efforts Now Underway to Streamline our Banking System.**

As Union Bank's petition well points out, there is a clear conflict in the circuits on the issue presented. The Sixth, Seventh and Tenth Circuits have each taken a much more expansive view of the ordinary course of business exception than the Ninth Circuit, and perhaps the Eleventh Circuit. This patchwork quilt of holdings could well have an adverse impact on existing interstate banking operations, as well as on efforts of the federal government and the banking industry to enhance the efficiency and competitiveness of the national banking system.

According to the Treasury Department's recently published recommendations for improving the banking system, the factors which have interfered with banking efficiency and competitiveness include "archaic restrictions on both geographic location and financial activities [which] have constrained banks ability to follow evolving markets, serve customers, and compete effectively." *Recommendations*, *supra* note 4, at 9. The

solution to this problem, according to the Treasury Department, is to eliminate "the artificial restrictions that constrain a bank's ability to make maximum use of its resources and expertise in serving customers." *Id.* at 10. In turn, "[n]ationwide banking and branching will make banks safer through diversification and more efficient through substantially reduced operating costs." *Id.*

The split in the circuits on the question presented, if unremedied, would require those banks which operate in two or more jurisdictions to develop a multiplicity of credit policies and train different groups of credit personnel. This problem will be acute not only within those Circuits which have ruled on the question. It will be as much of a problem--if not more--in jurisdictions in which the Circuit Court of Appeals has not yet ruled. Moreover, those banks which operate only in jurisdictions adopting the Ninth Circuit's holding--such as many of the members of the CBA--will be at an unfair and unwarranted competitive disadvantage to those banks which lend only in jurisdictions which grant § 547(c)(2) protection to commercial lenders.

Regional differences in substantive law, of course, are not uncommon in our federal system and will no doubt continue to vex banks and other lenders competing regionally or nationally. However, a body of national law such as the Bankruptcy Code should not contribute to the problem. It should be capable of uniform and consistent application so that creditors in one region will have the same rights in a problem loan situation as do creditors in other regions. Certainly, the split in the Circuits should not be allowed to hinder continuing efforts to modernize our national banking system.

CONCLUSION

Union Bank's Petition for Writ for Certiorari should be granted.

Dated: April 23, 1991

Respectfully submitted,

Mason C. Brown
Counsel of Record
Robert L. Morrison
Kenneth N. Russak
PILLSBURY, MADISON & SUTRO

Attorneys for *Amicus Curiae*
CALIFORNIA BANKERS' ASSOCIATION

APPENDIX

Table 1: Remaining Maturity Distribution of Commercial
Bank Loans, For all Banks, December 31, 1990
Fixed Rate Loans Totalling: $1,013,634,383
(Dollar Amounts in Thousands)

0-3 Months: $205,419,843 20.27%	3-12 Months $144,704,985 14.28%	1-5 Years $423,833,241 41.81%	Over 5 Years $239,676,314 23.65%
	0-12 Months $350,124,828 34.54%	Over 12 Months $663,509,555 65.46%	
0-3 Months $205,419,843 20.27%	Over 3 Months $808,214,540 79.73%		

Source: FDIC Database of Bank Call Reports
Transmitted by Letter Report To Counsel

Chart of Table 1
Nationwide Maturity Distributions

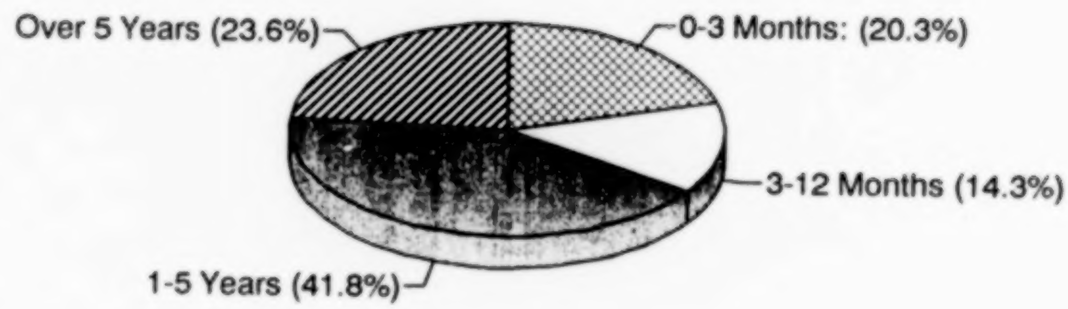

Table 2: Remaining Maturity Distribution of Commercial Loans, for Reporting California Major Domestic and Regional Banks (Excluding Immediate or 1 Day Maturities)
Loans Totalling: $96,204,297
(Dollar amounts in Thousands)

1 Day-3 Months $16,025,858 16.66%	3-12 Months $7,046,594 7.32%	1-5 Years $26,595,914 27.65%	Over 5 Years $46,535,931 48.37%
	1 Day-12 Months $23,072,452 23.98%	Over 12 Months $73,131,845 76.02%	
1 Day-3 Months $16,025,858 16.66%	Over 3 Months $80,178,439 83.34%		

Source: 1991 Findley Reports on California Banks

Chart of Table 2
California Maturity Distributions

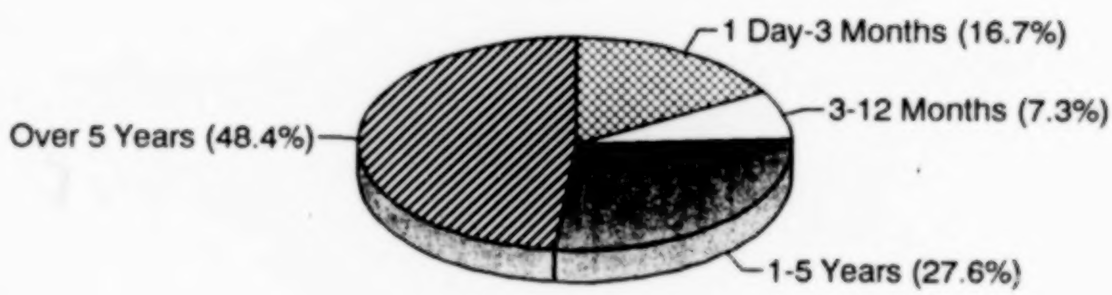

Table 3: Repricing Intervals for Commercial
Bank Loans, For all Banks, December 31, 1990
Variable Rate Loans Totalling: $1,032,126,144
(Dollar Amounts in Thousands)

0-3 Months: $840,957,006 81.48%	3-12 Months $146,565,127 14.20%	1-5 Years $36,971,074 3.58%	Over 5 Years $7,632,937 0.74%
	0-12 Months $987,522,133 95.68%	Over 12 Months $44,604,011 4.32%	
0-3 Months $840,957,006 81.48%	Over 3 Months $191,169,138 18.52%		

Source: FDIC Database of Bank Call Reports
Transmitted by Letter Report To Counsel

(5)

No. 90-1491

IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

UNION BANK,
Petitioner

v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,
Respondent

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

JOINT APPENDIX

JOHN A. GRAHAM
Counsel of Record
LESLEY ANNE HAWES
FRANDZEL & SHARE
A Law Corporation
6500 Wilshire Blvd.
Seventeenth Floor
Los Angeles, CA 90048
(213) 852-1000

DONALD R. MEYER
STEPHEN H. WEISS
UNION BANK
Counsel for Petitioner

TERRY A. ICKOWICZ
Counsel of Record
WOLAS, SOREF & ICKOWICZ
A Professional Corporation
1801 Century Park East
Suite 1717
Los Angeles, CA 90067
(213) 277-0408
Counsel for Respondent

PETITION FOR CERTIORARI FILED MARCH 26, 1991
CERTIORARI GRANTED MAY 13, 1991

4/pgs

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 90-1491

UNION BANK,

Petitioner

v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,

Respondent

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

RELEVANT DOCKET ENTRIES

DATE	FILINGS—PROCEEDINGS
	UNITED STATES BANKRUPTCY COURT
	* * * *
11/25/87	Complaint
2/5/88	Answer
5/10/88	Notice of Motion and Motion for Summary Judgment and for an Adjudication of Controversies of Fourth Claim for Relief filed by Union Bank (with supporting memorandum of points and authorities and declaration of Susan Russell)
	* * * *
5/23/88	Reply and Cross-Motion for Summary Judgment and Memorandum of Points and Authorities in Support Thereof (filed by Herbert Wolas)
5/26/88	Statement of Uncontroverted Facts and Conclusions of Law (filed by Union Bank)

DATE	FILINGS—PROCEEDINGS
6/3/88	Union Bank's Memorandum of Points and Authorities; Opposition to Trustee's Cross-Motion for Summary Judgment and Reply to Trustee's Response to Union Bank's Motion for Summary Judgment
6/3/88	Union Bank's Evidentiary Objections to the Declarations of Terry A. Ickowicz, Herbert Wolas and Donald R. Wagner
6/10/88	Response to Union Bank's Evidentiary Objections to the Declarations of Terry A. Ickowicz, Herbert Wolas and Donald R. Wagner
6/10/88	Union Bank's Supplemental Evidentiary Objections to the Declaration of Terry A. Ickowicz
7/11/88	(Proposed) Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief (lodged)
	* * * *
7/18/88	(Proposed) Findings of Fact and Conclusions of Law (lodged and not signed)
7/18/88	Objections by Plaintiff to Defendant's Findings of Fact and Conclusions of Law
	* * * *
8/23/88	Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief (entered) (Reprinted as Appendix C to Petition)
8/23/88	Findings of Fact and Conclusions of Law (entered) (Reprinted as Appendix D to Petition)
	* * * *
	UNITED STATES DISTRICT COURT
	* * * *
8/4/89	Order Affirming Judgment (Reprinted as Appendix B to Petition)
	* * * *

DATE	FILINGS—PROCEEDINGS
	UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT
	* * * *
6/25/90	Request for Determination of Appeal En Banc (filed by Union Bank)
11/26/90	Order Requiring Filing of Supplemental Brief by Appellee Union Bank
11/29/90	Supplemental Brief of Appellee Union Bank
12/3/90	Letter Brief of Appellant
12/28/90	Per Curiam Opinion (reversing Order of District Court) (Reprinted as Appendix A to Petition)
	* * * *

(4)

No. 90-1491

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

UNION BANK,
Petitioner,
v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF OF PETITIONER

JOHN A. GRAHAM
Counsel of Record
LESLEY ANNE HAWES
FRANDZEL & SHARE
A Law Corporation
6500 Wilshire Blvd.
Seventeenth Floor
Los Angeles, California 90048-4920
(213) 852-1000

DONALD ROBERT MEYER
General Counsel
STEPHEN HOWARD WEISS
Deputy General Counsel
UNION BANK
445 South Figueroa Street
Los Angeles, California 90071-1602
(213) 236-5906

Attorneys for Petitioner, Union Bank

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTIONS PRESENTED

1. Bankruptcy Code § 547(c)(2) protects otherwise preferential payments from recovery by a trustee in bankruptcy if the payments are (a) made on a debt incurred in the ordinary course of business of the debtor and the creditor, (b) made in the ordinary course of business, and (c) made in accordance with ordinary business terms. Is there an unwritten limitation under Bankruptcy Code § 547(c)(2) by which the statute only protects payments on short-term trade debt from recovery; or, should Bankruptcy Code § 547(c)(2) be applied in accordance with its plain meaning to protect all debts incurred in the ordinary course of business, whether a debt is long-term or short-term, because literal application of the statute is not demonstrably at odds with the intention of the drafters?

If the Court concludes that § 547(c)(2) draws a distinction between payments on short-term debt, which would be protected, and payments received on long-term debt, which would not be, then the following additional question is presented for determination:

2. Did the Ninth Circuit err by failing to define "long-term" debt in accordance with generally accepted accounting principles, income tax rules, and the general course of dealing in business transactions, thereby denying commercial lenders legal certainty in the application of Bankruptcy Code § 547(c)(2)?

LIST OF PARTIES

The list of parties submitted in the Petition for Writ of Certiorari remains an accurate representation of the information required by the Court regarding the parties to this proceeding.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 90-1491

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF OF PETITIONER

OPINIONS BELOW

On December 28, 1990, the Court of Appeals for the Ninth Circuit issued its opinion reversing the order of the district court that had affirmed the bankruptcy court's judgment in favor of Petitioner, Union Bank. The opinion is reported at 921 F.2d 968 and reprinted as Appendix A to the Petition for Writ of Certiorari.

On August 8, 1989, the District Court for the Central District of California entered its Order Affirming Judgment, affirming the summary judgment of the bankruptcy

court granted in favor of the Bank. The district court order was appealed by the Respondent to the court of appeals. The district court order was not published and is reprinted as Appendix B to the Petition for Writ of Certiorari.

The judgment of the Bankruptcy Court for the Central District of California which granted summary judgment in favor of the Petitioner, from which appeal was taken by the Respondent to the district court, was not published. The bankruptcy court's Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief, entered August 23, 1988, and Findings of Fact and Conclusions of Law related thereto, are reprinted in Appendices C and D, respectively, to the Petition for Writ of Certiorari.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was entered on December 28, 1990, reversing the order in favor of the Petitioner entered by the district court that affirmed the judgment of the bankruptcy court. Union Bank filed its Petition for Writ of Certiorari with this Court on March 26, 1991, pursuant to 28 U.S.C. § 1254(1), and the Petition for Writ of Certiorari was granted by this Court on May 13, 1991.

STATUTES INVOLVED

This case involves a lawsuit filed by Respondent, a bankruptcy trustee, to recover from Union Bank certain monthly interest payments and a small monthly loan fee as preferential transfers under § 547(b) of the Bankruptcy Code, Title 11 of the United States Code. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 1549. Section 547(b) provides:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would have received if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

There are exceptions to the trustee's ability to avoid certain transfers under 11 U.S.C. § 547 that are set forth in § 547(c). The exception upon which the Petitioner has relied to defend against the trustee's preference action is § 547(c)(2), which provides as follows:

> The trustee may not avoid under this section a transfer—
>
> . . . .
>
> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (C) made according to ordinary business terms.

STATEMENT OF THE CASE

The preference statute allows a trustee to recover from a creditor payments made to the creditor within 90 days of bankruptcy on account of an antecedent debt if by retaining the payments the creditor would receive more than it would have received in a Chapter 7 liquidation. 11 U.S.C. § 547(b).[1] However, even if the trustee establishes each of the elements of a preferential transfer under § 547(b), the Bankruptcy Code exempts certain preferential transfers from recovery by the estate.

The preference recovery exception at issue in this case is the provision that exempts "ordinary course of business" payments from avoidance. The creditor must demonstrate that (a) the debt was incurred in the ordinary course of the debtor's and the creditor's business or financial affairs, (b) the payment was made in the ordinary course of business or financial affairs of the debtor and the creditor, and (c) the payment was made in accordance with ordinary business terms.

On December 16, 1986, the Bank and ZZZZ Best (the "debtor") entered into a revolving credit agreement pursuant to which the Bank agreed to provide the debtor with a revolving line of credit in the sum of $7 million. Appendix D to Petition, p. 12a, Findings of Fact para. 1. The Bank's lending relationship with the debtor was further evidenced by a promissory note dated December 17, 1986. App. D to Pet., p. 12a, Findings of Fact para. 2.

The loan documents required the debtor to make monthly interest payments on the unpaid principal balance outstanding on the line and a small monthly loan commitment fee calculated according to the amount of any unused credit available under the line. App. D to Pet., p. 12a, Findings of Fact paras. 1 and 2. The debtor also executed an "Authorization for Disbursement" that authorized the Bank to charge the debtor's checking account automatically at the end of the month for the monthly interest and commitment fees required to be paid under the line of credit. App. D to Pet., p. 12a, Findings of Fact para. 3.

[1] If the recipient *or* beneficiary of the payment is an "insider," payments within one year of bankruptcy are recoverable as preferences. 11 U.S.C. §§ 101(31) and 547(b)(4)(B); *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1986).

The debtor timely made the routine monthly interest payments and paid the monthly loan fees, when applicable, until July 1987. App. D to Pet., pp. 13a-14a, Findings of Fact para. 6, Conclusions of Law paras. 4-6, inclusive. These payments included (a) a loan fee in the sum of $2,511.38 made on April 10, 1987; (b) a monthly interest payment in the sum of $48,951.39 made on April 30, 1987; and (c) a monthly interest payment in the sum of $52,869.44 made on June 1, 1987.

On July 8, 1987, the debtor filed its voluntary petition under Chapter 7 of the Bankruptcy Code. App. D to Pet., p. 13a, Findings of Fact para. 7. Herbert Wolas, the Respondent herein, was appointed as the Chapter 7 trustee of the debtor's estate. The trustee filed a preference action against the Bank to recover the monthly loan payments referenced above.

The Bank filed a motion for summary judgment asserting that even if all the payments were preferential under § 547(b), the payments were not recoverable by the estate because they were protected by the ordinary course of business exception of § 547(c)(2). The trustee contended that, as a matter of law, the payments were recoverable by the estate because: (a) the ordinary course of business exception does not apply to "long-term" debt or non-trade debt; and (b) the ordinary course of business exception does not apply in this case because the debtor was involved in a Ponzi[2] type of scheme.

[2] The Ninth Circuit defines a Ponzi scheme as "any sort of fraudulent arrangement that uses later acquired funds or products to

The bankruptcy court rejected both of the trustee's contentions, ruling that § 547(c)(2) applied to all debt, not just trade debt, and that the loan in question was incurred by the debtor and made by the Bank in the ordinary course of the parties' businesses. For the purposes of examining the trustee's cross-motion for summary judgment, the court considered the alleged facts that the debtor engaged in fraudulent business activities [3] and the Ponzi scheme line of cases in which courts have required equality of distribution among a defrauded class of similarly situated investors. However, the court ruled that the Ponzi scheme cases were not applicable to the Bank in this case since the Bank received the payments in question as a commercial lender in a routine loan transaction, was not an investor, and had no claim to any extraordinary profits such as the investor in a Ponzi scheme would typically have. App. D to Pet., pp. 14a-15a, Conclusions of Law paras. 9 and 10.

On appeal from the district court, the Ninth Circuit reversed, holding that as a matter of law, under its recent ruling in *Matter of CHG Int'l, Inc. (CHG Int'l, Inc. v. Barclays Bank)*, 897 F.2d 1479 (9th Cir. 1990), payments on long-term debt are not protected from recovery under § 547(c)(2).[4] The Ninth Circuit further ruled that because the debt held to be long-term in *CHG* had a term of seven months and the debt in this case had an eight and one-half month term, the debt in this case was long-term and the payments were recoverable

---

pay off previous investors." *In re Bullion Reserve of N. Am. (Danning v. Bozek)*, 836 F.2d 1214, 1219 n.8 (9th Cir. 1988).

[3] The Bank submitted extensive evidentiary objections to the hearsay declarations submitted by the trustee on the alleged Ponzi scheme issue. Because of the bankruptcy court's ruling on the legal issues, the bankruptcy court did not reach the evidentiary objections.

[4] The *CHG Int'l* decision was rendered after the Bank prevailed in the district court and the matter had been fully briefed in the court of appeals.

by the trustee. The Ninth Circuit expressly did not reach the trustee's second argument regarding the Ponzi scheme issue.

In the face of contrary decisions in several other circuits, this Court granted the Bank's Petition for Writ of Certiorari.

SUMMARY OF ARGUMENT

The preference statute of the Bankruptcy Code of 1978 employs a two-step process to determine whether a prepetition payment made by the debtor in favor of a creditor is recoverable by the estate. Section 547(b) sets forth five criteria that must be met to establish that a preferential payment has been made, including that the payment was made on an antecedent debt within 90 days of the date of bankruptcy (for a non-insider) and that retention of the payment would allow the creditor to receive more than it would have otherwise received on its claim in a Chapter 7 liquidation of the debtor's assets.

Those payments that qualify as preferences under this test may nevertheless escape avoidance by the trustee if they come within one of several statutory exceptions. Section 547(c)(2), the "ordinary course of business" exception, protects payments (a) made on "a debt incurred by the debtor in the ordinary course of business or financial affairs," (b) made in the ordinary course of business or financial affairs of the debtor and the creditor, and (c) made in accordance with ordinary business terms.

Under the plain meaning of the statute's language, there is no basis for finding § 547(c)(2) applicable to short-term or trade debt but inapplicable to long-term debt. Neither the statutory definition of the term "debt" nor any other provision of the Code suggests any such distinction, though the Code contains other instances where Congress clearly distinguished between trade and other kinds of debt. Further, in 1984 Congress repealed

a provision in the original 1978 Bankruptcy Code which had limited § 547(c)(2) to payments on debts made within 45 days of the date the debt was incurred. In doing so, it rejected, because of dissatisfaction with its practical operation, precisely the type of requirement that the Ninth Circuit here found operative.

The legislative history fully supports the plain meaning of the statute's words. The 45-day limitation, in effect for only six years, was a departure from 80 years of prior practice under the Bankruptcy Act of 1898. Under the Act, avoidance of a preference turned on a showing that the creditor at the time of the payment had reasonable cause to believe that the debtor was insolvent, and contained no limit on the term of the debt. The Bankruptcy Code abandoned the "reasonable cause to believe" requirement in favor of an objective test for determining a preference, which included the limitation of the ordinary course exception to payments made within 45 days of the date the debt was incurred. As indicated by substantial testimony before Congress in the early 1980s, the provision was widely viewed as unsatisfactory because it did not reliably serve in practice to protect payments on debts made in the ordinary course of business. The 1984 repeal of the 45-day provision was intended to address that concern. Nothing in the legislative history suggests in any way that a residual limitation remained, confining the exception to debt of a particular term.

The policies behind the preference provisions also support the apparent meaning of the words of § 547(c)(2). The two general policies of the preference statute are to promote equality of distribution and to discourage unusual action by either the debtor or the creditor that might precipitate a race to dismember the debtor's assets during its financial decline. These policies are not undermined by the application of the statute according to its terms to both long-term and short-term debt.

The Ninth Circuit's judicially created limitation would not advance the policy of equality of distribution, since payments on short-term debt, no less than long-term debt, allow particular parties to get more than they would receive in a liquidation of the debtor's assets under Chapter 7. Further, such a limitation actually impairs the second policy of the preference statute—to discourage unusual action by the debtor or creditor that might speed the debtor's economic decline. It would penalize creditors who continue to carry on normal dealings with the debtor as its business declines and thereby exacerbate the unavailability of credit.

Only if the Court concludes that an unwritten limitation should be inferred by which payments on short-term debt alone are protected would the Court need to address the distinction between short- and long-term debt. If so, Petitioner submits that the one-year cutoff, dictated by generally accepted accounting principles and commercial practice, should be adopted to create legal certainty in the application of the exception.

ARGUMENT

I. BANKRUPTCY CODE § 547(c)(2), THE ORDINARY COURSE OF BUSINESS EXCEPTION TO THE PREFERENCE RULE, DOES NOT DISTINGUISH BETWEEN SHORT-TERM AND LONG-TERM DEBT.

A. The Statute Is Unambiguous and Its Plain Language Is Conclusive in This Case.

The interpretation of any statute must begin with the language of the statute itself. *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. ——, 109 L. Ed. 2d 588, 595, 110 S. Ct. 2126 (1990). Absent exceptional circumstances, the plain meaning of the statute controls. *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571, 73 L. Ed. 2d 973, 102 S. Ct. 3245 (1982). In interpreting the Bankruptcy Code, this Court recently stated:

> The plain meaning of legislation should be conclusive, except in the "rare cases [in which] the literal ap-

> plication of a statute will produce a result demonstrably at odds with the intentions of its drafters." [Citation omitted.]

United States v. Ron Pair Enter., Inc., 489 U.S. 235, 242, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989). *See also Toibb v. Radloff*, 59 U.S.L.W. 4633, 4634 (June 13, 1991) (in which the Court refused to infer a limitation on individuals eligible for protection under Chapter 11 by holding that "the plain language of the statute disposes of the question before us").

At issue is the proper interpretation of the phrase "a debt incurred by the debtor in the ordinary course of business or financial affairs." 11 U.S.C. § 547(c)(2). Specifically, the question is whether that exception is limited in a manner not stated in the statute to short-term or trade debt, as distinguished from long-term or other commercial obligations. Nothing in the statute supports such a reading.

The term "debt" is specifically defined in the Bankruptcy Code as "liability on a claim." 11 U.S.C. § 101(12). It is not qualified in any other way. The original version of the Bankruptcy Code, as enacted in 1978, included a requirement within the ordinary course of business exception of § 547(c)(2) that the transfer at issue be "made not later than 45 days after such debt was incurred." The deletion of this provision in the Bankruptcy Amendments and Federal Judgeship Act of 1984 removed any limitation on the term of the debt excepted. *See* Pub. L. No. 98-533, 98 Stat. 333 (1984).

Other portions of the Code illustrate that Congress was familiar with different types of debt and capable of drawing distinctions among them. In fact, § 1304(a) of the 1978 Bankruptcy Code uses the term "trade credit" in a provision that permits a Chapter 13 debtor to incur such credit post-petition without court approval. *See also* 11 U.S.C. § 101(49)(b)(vii) (in which Congress excluded from the definition of security "debt or evidence of in-

debtedness for goods sold and delivered or services rendered").

The court below did not suggest that the language of the statute itself supports its interpretation, nor did the Ninth Circuit find that the language of the statute is ambiguous. In fact, the Ninth Circuit acknowledged that the "literal" application of the statute would make no distinction whatsoever among loans according to the duration of the loan or the character of the credit so long as the "ordinariness" standard was satisfied. *CHG Int'l*, 897 F.2d at 1484 ("a literal . . . reading of the new section 547(c)(2) appears to remove the primary obstacle which excluded these [long-term] loans from the exception").

The conclusion reached by the court below can only be justified on the obviously false assumption that the court knows better than Congress itself what Congress must have intended.[5] Faced with the identical issue presented here, the United States Court of Appeals for the Sixth Circuit found no distinction under § 547(c)(2) between short-term and long-term debt, *In re Finn* (*Gosch*

---

[5] The Ninth Circuit reasoned that ordinary course payments on trade debt should be protected for policy reasons (but payments on long-term debt should not) because those payments on trade debt do not diminish the estate and are not payments on an antecedent debt, and trade creditors "replenish" the estate by continuing to provide new goods and services to the debtor. *CHG Int'l*, 897 F.2d at 1483. The court's rationale ignores the other exceptions of the Code that protect from recovery "substantially contemporaneous" exchanges (§ 547(c)(1)) and preferential payments to the extent the creditor gives the debtor new goods, money or services after receiving the preference (§ 547(c)(4)). Thus, there are other exceptions to the preference statute that address the policy considerations cited by the Ninth Circuit. The ordinary course of business exception was designed to address different concerns: "to leave undisturbed normal financial relations" and to "discourage unusual action by either the debtor or his creditors." H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* App. 2 Collier on Bankruptcy ch. II (15th ed. 1990).

v. Burns), 909 F.2d 903, 907-08 (6th Cir. 1990), and characterized the contrary view as

> import[ing] too much assumed history into the barren language of the statute. On its face, the pre-1984 language applied to all debt incurred "in the ordinary course," and the limitation came from requiring the payment within 45 days of the debt. By eliminating the 45-day limitation, and neither stating nor implying any other limitation, Congress's language left the field open to long-term consumer debt for exception under § 547(c)(2). Some courts take the position, as *In re Control Electric*, that without legislative history to back it up, a change in the language of the statute is not to be respected. . . . We reject this method of statutory interpretation.

The Ninth Circuit's failure to heed the words of the statute and the repeal of the 45-day limitation runs counter to this Court's clear admonition that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 99 L. Ed. 2d 169, 108 S. Ct. 968 (1988). The language is clear: it imposes no restriction on the type of debt that falls within the ordinary course of business exception; it does not refer to a limit on the term of the debt or set time periods for the date the debt was incurred and the date the payment was made. Any such time limitation was eliminated by Congress when it deleted the 45-day rule. It is improper for the judiciary to reimpose such a time limitation in the face of deliberate action by Congress to eliminate such a restriction.

B. The Plain Meaning of § 547(c)(2) Is Supported by the Legislative History.

The Bankruptcy Act of 1898 protected most ordinary-course payments against avoidance as a preference and did not distinguish between short- and long-term debt.

An analysis of the former law indicates that it was the 45-day limitation that radically departed from *80 years* of prior bankruptcy practice.

Section 60 of the Bankruptcy Act of 1898, as amended in 1938,[6] governed the recovery of preferences. Subsection (a) of § 60 set forth the tests for determining whether the transfer of property was preferential. If the trustee established that the transfer was preferential, the trustee was still required to prove that the transfer was recoverable by the estate by meeting the requirements of § 60(b), including a showing that the creditor benefited had, "at the time when the transfer [was] made, reasonable cause to believe that the debtor [was] insolvent."

Under the old Act, many preferential payments on both trade debt and long-term obligations were not recovered because of the difficult burden faced by the trustee to prove the state of mind of the creditor and his knowledge of the debtor's financial circumstances. *See, e.g.*, H.R. REP. NO. 595, 95th Cong., 1st Sess. 178-79 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990). In the Bankruptcy Reform Act of 1978, Congress endeavored to correct the problem of proof faced by the trustee under the old Act by eliminating the "reasonable cause to believe" requirement and creating a presumption of insolvency during the 90 days preceding the filing. H.R. REP. NO. 595 (95th Cong., 1st Sess. 178-79 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990).

In revamping the preference provisions of the Bankruptcy Act, the 1978 Code was restructured to state that all preferences are recoverable unless they meet one of several exceptions. One of those exceptions is § 547(c)(2). The House and Senate reports submitted in con-

[6] 11 U.S.C. § 96 (*repealed by* the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978)).

nection with the 1978 Bankruptcy Code include the following explanation of the purpose of the ordinary course of business exception:

> The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* App. 2 Collier on Bankruptcy ch. II (15th ed. 1990); S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* App. 3 Collier on Bankruptcy ch. V (15th ed. 1990).

The inference that the 1978 statute was intended to apply only to trade debt or other short-term debt arose from the provision of § 547(c)(2) limiting the protection to payments made within 45 days of the date the debt was incurred. The 45-day rule is not addressed specifically in the legislative history of the 1978 Code, and the rule had unintended consequences that were brought to Congress's attention in a series of hearings commencing in 1980 that culminated in the deletion of the rule in 1984.

During hearings conducted by the Senate beginning in 1980 to evaluate the operation of the new Bankruptcy Code, numerous scholars and practitioners criticized the operation of the 45-day rule. At Senate hearings on Senator DeConcini's bill to amend § 547(c) to include a special provision protecting payments made on commercial paper,[7] Professor Lawrence King, a noted bankruptcy scholar and member of the National Bankruptcy Conference, responded to questions regarding the proposed amendment. Professor King suggested that instead of taking a piecemeal approach to protect ordinary course

[7] S. 3023, 96th Cong., 2d Sess. (1980).

payments, "The whole section needs to be looked at. It just does not work," and that the reenactment to the reasonable cause to believe requirement "would solve a lot of problems." Hearing Before the Subcomm. on Judiical Machinery of the Senate Comm. on the Judiciary, 96th Cong., 2d Sess. 4 (1980) (statement of Lawrence King, Professor, School of Law, New York University).

In hearings conducted in 1981, various changes to the preference statute were suggested. The central theme was that regular payments made on debt in accordance with the terms of the credit arrangement should not be recoverable since preference exposure for such payments was disrupting normal financial relations and tightening the availability of credit. *See generally* Hearings Before the Subcomm. on Courts of the Senate Comm. on the Judiciary, 97th Cong., 1st Sess. 229-75, particularly 245, 259, 260 (1981) (hereinafter cited as "1981 Hearings").

For example, one witness testified that "the operation of preference litigation should not impair or impede normal commercial transactions," and that if it did, the "beneficial purposes may be outweighed by the damage they do in the real world of business and commerce." 1981 Hearings, at 254. The ordinary course of business exception "was not intended to change how people did business" according to another witness. 1981 Hearings, at 245.

Thereafter, the Senate introduced the Bankruptcy Improvements Act of 1981. The bill proposed to add back into the preference statute the "reasonable cause to believe" requirement from the former Bankruptcy Act. S. 2000; S. Rep. No. 446, 97th Cong., 2d Sess. (1982). The report accompanying the bill evidences a specific intention that ordinary course of business payments on all types of debt that satisfy the "ordinariness" criteria not be recoverable. S. Rep. No. 446, 97th Cong., 2d Sess. 24 (1982). The report's analysis of the specific sections of S. 2000 includes the following comments:

> The trustee retains the power to avoid liens and recover payments where a creditor knowingly applies last minute pressure on an insolvent debtor in the hope of obtaining more favorable treatment that [sic] the creditor would receive in bankruptcy. The amendment will permit regular payments, made voluntarily by the debtor in the ordinary course of business and prior to filing of the petition, to be retained by the creditor.
>
> . . . .
>
> The removal of the "reasonable cause to believe" requirement from the preference section in the 1978 act had unforeseen consequences in industries dependent upon installment credit payments.
>
> The amendment will restore the balance in the section and permit only those payments which are true preferences to be recovered.

S. REP. No. 446, 97th Cong., 2d Sess. 42-43 (1982).

Additional hearings on amendments to the Code were held in 1983,[8] in which there was further criticism of the disruptive effect of the 45-day rule on consumer lending transactions, particularly retail installment contracts.[9] Also during 1983, the Omnibus Bankruptcy Improvements Act of 1983 was introduced, not only reimposing the "reasonable cause to believe" requirement but also deleting the 45-day rule from § 547(c)(2). S. 445; S. REP. No. 65, 98th Cong., 1st Sess. 14 (1983) (report to accompany S. 445). Ultimately, the preference provisions of S. 445 were modified to omit the "reasonable cause to believe" requirement, among others, and were incorporated into and passed as part of the miscellaneous substantive and technical amendments of the Code in the Bankruptcy Amendments and Federal Judgeship Act ("BAFJA") of 1984. Congress implicitly decided not to reintroduce the "reasonable cause to believe" requirement for the same reasons that it had eliminated the requirement in 1978: to avoid litigation over the state of mind of the creditor as a condition to the avoidance of a preference. In eliminating the 45-day rule, however, the amendments as enacted returned creditors to the state of affairs under the Act, where the term of the debt was irrelevant in determining whether a preference was avoidable.

[8] No action was taken by the full Senate on proposed S. 2000 before the conclusion of the legislative term.

[9] *See* Exhibit 1 to April 6, 1983 Hearing Before the Senate Comm. on the Judiciary (*Report and Recommendation* by the Consumer Bankruptcy Subcomm. of the Comm. on Consumer Financial Services of the American Bar Ass'n Section on Corporation, Banking and Business Law). Retail installment contracts are long-term debts, and payments on those contracts would not be protected by the ordinary course of business exception because of the 45-day rule.

The reports accompanying both Omnibus bills indicate that Congress balanced the competing interests and the outcomes that would result from the amendment of the statute and found that it was more important to promote normalized business dealings with creditors than to increase the potential preferential payments that could be recovered in bankruptcy. S. Rep. No. 446, 97th Cong., 2d Sess. 24 (1982); S. Rep. No. 65, 98th Cong., 1st Sess. 13-14 (1983). Nothing in the legislative history of § 547(c)(2) suggests that Congress intended to exclude from the protections of that statute any particular class of creditor whose debt and the payments thereon otherwise meet the statutory criteria of the amended statute.

C. The Policies of the Preference Provisions Also Support the Plain Meaning of the Statute.

The preference provisions of the Bankruptcy Code were designed to promote two general policies: (1) equality of distribution among similar classes of creditors; and (2) discouragement of unusual action by creditors that might prompt a race to the courthouse and dismemberment of a debtor's assets. *See, e.g.*, H.R. REP. No. 595, 95th Cong., 1st Sess. 177-78 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990).

The first policy—equality of distribution—is theoretically achieved by returning to the estate payments that creditors received from the debtor's assets that would otherwise allow those creditors to receive more than they would have received in a Chapter 7 liquidation. However, Congress determined that certain admittedly preferential payments, which by definition should be returned to the estate under this rule, need not be recovered for policy reasons. The equality of distribution principle provides no basis for distinction between payments on short-term and long-term debt made during the preference period since both deplete the estate to the same degree.

The second policy—discouragement of unusual action by creditors—is achieved by constructing a statute which does not penalize creditors that continue their regular financial dealings with the debtor. In that regard, a rule that di[illegible]tes against the long-term lender only restricts [illegible]ilability of credit (*see* 1981 Hearings, at 259) and provides an incentive for the lender to assert financial covenant defaults under its loan documents at the first sign of a debtor's financial distress. Even if depletion of the estate were the paramount concern of § 547(c)(2), the Ninth Circuit's rule does not better protect the estate against depletion than does the contrary rule. Treating short-term and long-term debt the same would encourage all creditors to continue to deal with the debtor under their normal loan terms without threat of preference exposure, thereby providing the debtor the benefit of the loan proceeds during its period of financial distress.

Under the Ninth Circuit's interpretation of the statute, if the lender were to continue to accept regular payments, the lender would suffer a double penalty: any payments made to the lender during the debtor's slide into bankruptcy would be recovered as preferential and the debtor could use the working capital and limited as-

sets of the business to pay trade creditors who would be entitled to retain any ordinary course payments made during that time frame, thus reducing the assets available to pay the lender's claim. The Ninth Circuit's interpretation of the statute undermines rather than promotes the goal of encouraging creditors to continue their normal financial dealings with the debtor during its financial difficulties and would ultimately result in the cutoff of ordinary course payments to trade creditors as long-term loans are called and the debtor is forced into bankruptcy prematurely.

While the Ninth Circuit recognized that Congress intended to protect payments made on commercial paper when it eliminated the 45-day rule (*CHG Int'l*, 897 F.2 at 1484), the court ignored the role that commercial paper plays in the financial operations of a business. Commercial paper is an alternative source of financing used by business to obtain working capital, just as the revolving line of credit provided by the Bank to the debtor in this case was designed to provide working capital for the debtor's operations. In effect, it is the capital from non-trade credit that provides the financial base for a business and permits a debtor to make ordinary course payments to its trade creditors. There is no basis in the policies behind the Code for inferring that Congress found the role long-term credit plays in a debtor's business to be less vital or less worthy of protection than trade credit or commercial paper when Congress eliminated the 45-day rule.

II. IF THE COURT RULES THAT § 547(c)(2) APPLIES ONLY TO SHORT-TERM DEBT, THEN A DEFINITION OF LONG-TERM DEBT SHOULD BE RECOGNIZED THAT ACCORDS WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND BUSINESS PRACTICES.

The Ninth Circuit in *CHG Int'l* ruled that "long-term" debt is not protected under the ordinary course of business exception. In *ZZZZ Best*, the Ninth Circuit ruled

by negative implication that because the loan in this case had a term longer than the loan held to be "long-term" in *CHG Int'l*, the payments to the Bank in this case were on long-term debt and were not exempt from recovery under § 547(c)(2). Unfortunately, the Ninth Circuit left the commercial world to guess as to the exact definition of short-term debt it was employing. Failure to follow the plain meaning of the statute would leave courts with the task of distinguishing between long-term debt and short-term debt with nothing in the Code to guide their determination.[10]

To avoid uncertainty, this Court should make reference to generally accepted accounting principles and commercial realities. Accounting standards accepted by the Internal Revenue Service and implemented in business practice provide that obligations with a term of less than one year be deemed short-term, current liabilities. RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, Accounting Research Bulletin No. 43, ch. 3 "Working Capital," § A7 (Am. Inst. of Certified Pub. Accountants 1953); S. Stern, *Structuring Commercial Loan Agreements* ¶ 6.03[1][b] (2d ed. 1990) (WG&L). A bright line test defining long-term debt to be debt of one year or longer would meet with general expectations in the business community, would provide a test that is

[10] The Ninth Circuit could have distinguished between repayment of the principal of long-term debt and payment of monthly interest on the debt as the Eighth Circuit did in *In re Iowa Premium Serv. Co., Inc. (Iowa Premium Serv. Co., Inc. v. First Nat'l Bank in St. Louis, etc.*, 695 F.2d 1109 (8th Cir. 1982). In *Iowa Premium*, the Eighth Circuit held that monthly interest payments on debt constitute payments on a short-term obligation incurred within 45 days of the date the debt was incurred. The Ninth Circuit rejected the *Iowa Premium* holding. *CHG Int'l*, 897 F.2d at 1486. If the Court rejects the plain meaning of the statute, courts will also have to struggle with the concept of whether the payment of interest is distinct from the repayment of the principal and whether the debt for interest is "short-term" even if the underlying loan is "long-term."

practical and easily implemented, and would avoid wasteful litigation into the issue whether the debt in a particular case is or is not long-term.

CONCLUSION

Neither the plain language of the statute nor the policies and purposes of the statute as reflected in the legislative history provide a basis for limiting the ordinary course of business exception of § 547(c)(2) to particular types of debt so long as the debt satisfies the criteria of the statute for "ordinariness." The holding of the Ninth Circuit that payments on long-term debt are not within the scope of § 547(c)(2) should be reversed.

Respectfully submitted,

JOHN A. GRAHAM
Counsel of Record
LESLEY ANNE HAWES
FRANDZEL & SHARE
A Law Corporation
6500 Wilshire Blvd.
Seventeenth Floor
Los Angeles, California 90048-4920
(213) 852-1000

DONALD ROBERT MEYER
General Counsel
STEPHEN HOWARD WEISS
Deputy General Counsel
UNION BANK
445 South Figueroa Street
Los Angeles, California 90071-1602
(213) 236-5906

Attorneys for Petitioner,
Union Bank

QUESTIONS PRESENTED

1. Did the Ninth Circuit correctly hold that payments of interest and loan charges made by ZZZZ Best Co., Inc. to Union Bank during the ninety day period prior to the filing of its Chapter 11 Petition on account of an eight and one-half month revolving line of credit extended by Petitioner to ZZZZ Best Co., Inc., constituted a voidable preference on a long-term loan, thereby excluding it from protection under 11 U.S.C. § 547(c)(2)?

If the Court concludes that 11 U.S.C. § 547(c)(2) protects the payment made by ZZZZ Best Co., Inc., to Union Bank on account of the long-term revolving line of credit loan obligation, then the following additional question is presented for determination:

2. Did the Ninth Circuit err by failing to find that ZZZZ Best Co., Inc. was engaged in a Ponzi scheme and, therefore, that the ordinary course of business exception found in 11 U.S.C. § 547(c)(2) does not protect the payments made to Union Bank?

LIST OF PARTIES

The parties to the proceedings below were the Petitioner, Union Bank, and the Respondent, Herbert Wolas, in his capacity as the Chapter 7 Trustee for the bankruptcy estate of ZZZZ Best Co., Inc.

TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 90-1491

UNION BANK,
Petitioner,
v.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF ON THE MERITS BY RESPONDENT

Herbert Wolas, the Respondent herein, prays that the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on December 28, 1990, be affirmed.

OPINIONS BELOW

The December 28, 1990 opinion of the Court of Appeals for the Ninth Circuit reverses the judgments of the district and bankruptcy courts. The opinion is reported at 921 F.2d 968 and reprinted as Appendix A to the Petition for Writ of Certiorari filed by Petitioner, at 1a.

On August 8, 1989, the District Court for the Central District of California (the "District Court") entered its Order Affirming Judgment, affirming the summary judgment of the bankruptcy court granted in favor of the Petitioner, Union Bank. The District Court order was appealed by the Respondent to the Court of Appeals for the Ninth Circuit. The District Court order was not published and is reprinted as Appendix B to the Petition for Writ of Certiorari filed by Petitioner, at 3a.

The order of the Bankruptcy Court for the Central District of California (the "Bankruptcy Court") granting summary judgment in favor of the Petitioner, from which appeal was taken by the Respondent to the District Court, was not published. The Bankruptcy Court's Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief, entered August 23, 1988, and Findings of Fact and Conclusions of Law related thereto, are reprinted in Appendices C and D to the Petition for Writ of Certiorari filed by Petitioner at 6a and 10a, respectively.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit in favor of Respondent was entered on December 28, 1990, reversing the judgments in favor of the Petitioner entered by the District Court and the Bankruptcy Court. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1). On May 13, 1991, this Court granted Petitioner's Petition for Writ of Certiorari.

STATUTES INVOLVED

The statute involved is 11 U.S.C. § 547(c)(2) which is set forth in Petitioner's Brief.

STATEMENT OF THE CASE

On November 25, 1987, the Trustee filed a Complaint against the Petitioner, Union Bank, alleging the receipt of preferential payments made to it by ZZZZ Best Co.,

Inc. ("ZBest") within 90 days prior to the date ZBest filed for relief under Chapter 11 of the United States Bankruptcy Code. On or about May 10, 1988, Union Bank brought its Motion for Summary Judgment and on May 23, 1988, the Trustee filed his Cross-Motion for Summary Judgment. On August 23, 1988, the Bankruptcy Court entered summary judgment in favor of Union Bank and against the Trustee and denied the Trustee's Cross-Motion for Summary Judgment.

The Trustee then filed his Notice of Appeal on August 29, 1988. After Union Bank objected to the jurisdiction of the Bankruptcy Appellate Panel for the Ninth Circuit, this case was referred to the District Court.

On August 8, 1989, the District Court, the Honorable David V. Kenyon presiding, affirmed the Order of the Bankruptcy Court granting summary judgment against the Trustee and in favor of Union Bank. The Trustee timely appealed to the United States Court of Appeals for the Ninth Circuit.

The events giving rise to the making of the preferential payments by ZBest to Union Bank are relatively simple. Essentially, on or about December 14, 1986, ZBest and Union Bank entered into a Revolving Credit Agreement whereby Union Bank agreed to loan ZBest the sum of $7 million. ZBest borrowed the entire $7 million credit facility on December 17, 1986.

To evidence the takedown of the funds, a commercial promissory note (the "Promissory Note") in the amount of $7 Million was executed on December 17, 1986. The Promissory Note stated a maturity date of August 31, 1987. In addition, the Promissory Note required the payment of interest at the rate of not less than $500.00 per month or 0.650% per year in excess of Union Bank's reference rate, whichever was greater on the outstanding principal loan amount.

The alleged business operation of ZBest with respect to its restoration contracts (which constituted substantially all of ZBest's alleged gross receipts) was a fraud since the alleged restoration contracts never existed and were entirely fictitious. The continuous borrowing and repayment of funds by ZBest from investors and creditors during its fraudulent operation and prior to its filing for relief under Chapter 11 was tantamount to a fraudulent scheme designed to induce investors and/or creditors to extend credit and to repay certain investors and/or creditor in order to induce said persons to further extend larger sums of credit. In essence, the operation of ZBest, as carried out by its officers and directors, was tantamount to the classic "Ponzi" scheme. The end result of the Ponzi scheme was the dissipation of all funds provided by investors and/or creditors to areas and/or persons unknown, with a total resulting loss to investors acquiring shares of stock in ZBest and large losses to creditors who extended credit.

After the Bankruptcy Court and District Court found for Petitioner, the Respondent Trustee appealed the District Court's ruling to the Court of Appeals for the Ninth Circuit.[1] A three-judge panel of the Ninth Circuit reversed in a *per curiam* opinion, relying on the decision of another panel of the court in *CHG International, Inc. v. Barclays Bank (Matter of CHG International, Inc.)*, 897 F.2d 1479 (9th Cir. 1990).

[1] The Ninth Circuit's jurisdiction to hear the appeal was provided by 28 U.S.C. § 158(d) which grants the circuit courts of appeals jurisdiction to hear appeals from final decisions of the district courts entered pursuant to 28 U.S.C. § 158(a) and (b).

SUMMARY OF ARGUMENT BY RESPONDENT

In *ZBest*, the Ninth Circuit held that interest payments made on account of a *long-term debt do not qualify* for the protection of the "ordinary course of business" exception of § 547(c)(2) *as a matter of law*. Furthermore, the Ninth Circuit's *Zbest* decision held that the eight and one-half-month revolving line of credit constitutes "long-term" debt for the purposes of § 547(c)(2) because one of the two debts in the prior Ninth Circuit decision in *CHG International* case had a term of seven months and was held to be long-term debt.

For the reasons hereinafter set forth, Respondent contends that as a matter of law, the Ninth Circuit correctly determined that the revolving line of credit constituted a long-term debt obligation of ZBest and that payments made on account of such indebtedness are not to be afforded protection under the provisions of § 547(c)(2). Specifically, the Petitioner would have this Court emasculate a long line of judicial and statutory protection provided to a debtor and creditors of the debtor's estate by having this Court determine the intent of Congress to do away with all long-standing rules regarding recovery of preference payments on long-term debt obligations to a lender. The Ninth Circuit *correctly* determined that the applicable exception to recovery of a preference by a trustee for the benefit of the creditors of an estate should only extend to short-term trade credit obligations and that the preference provisions should not be a rule swallowed up by exceptions. The Ninth Circuit *correctly* concluded that the 1984 amendment to the statute by Congress was not intended to extricate all transfers on account of antecedent debts; rather, it was intended to provide assurances to trade creditors who continued to provide value to a debtor that payments received during a preference period would not be subject to attack by a trustee so long as value was equally exchanged. More importantly, the scant legislative his-

tory, coupled with the fact that Congress only eliminated an artificial time limitation under § 547(c)(2), further supports the Ninth Circuit's analysis and conclusions.

In the case at bar, the value of all funds received by ZBest from Petitioner were dissipated by it during its operation of a fraudulent business activity. The continued perpetuation of the fraudulent activity was the direct result of ZBest maintaining the status quo on its long-term debt obligations to Petitioner to avert the Petitioner seeking legal redress which may have resulted in an earlier collapse of ZBest's fraudulent business operation. Specifically, the ZBest operation was not a legitimate business operation and, as the Bankruptcy Court noted, may not have been sufficient to constitute a going concern such that the debt obligation incurred by it to Petitioner was incurred in its ordinary course of business inasmuch as ZBest may not have had an ordinary course of business.

The Petitioner is quick to point out that the Ninth Circuit did not define what constitutes "long-term" debt. Petitioner's Brief on the Merits ("Petitioner's Brief") at p. 20. However, this is not an appropriate statement. The Ninth Circuit defined what is not short-term debt and, specifically determined that an eight and one-half-month revolving line of credit was tantamount to a long-trem debt obligation.

The Ninth Circuit Court of Appeals *correctly* determined that the revolving line of credit constituted a long-term debt obligation and, therefore, as a result thereof, the payments made by ZBest to Petitioner, Union Bank, were not within the ordinary course of business exception to the transfers which are otherwise preferential. In so holding, the Ninth Circuit determined that the plain Congressional intent of the statute was merely to remove an artificial time period for determining the date upon which a debt is incurred and in connection therewith, to focus attention upon the benefit to the estate of

the debtor through the value received in exchange for payments made.

It is clear that the Congressional modification to § 547(c)(2) was not intended to overrule a long line of statutory and judicial history since *no* such meaning can be gleaned from the Congressional reports. Rather, what is clear is that the Congress intended to provide protection to trade creditors who continued doing business with a debtor during the debtor's slide into bankruptcy. This intent is more fully set forth at the Notes of Committee on the Judiciary, S. Rep. No. 989, 95th Cong., 2nd Sess. (1978), *infra.*

In making its argument, the Petitioner attempts to have this Court set forth and define a *bright line* test as to what constitutes a long-term debt or a short-term debt obligation. After reaching this determination, Petitioner requests this Court to determine that § 547(c)(2) protects long-term debt and short-term debt. Petitioner makes reference to generally accepted accounting principles but, however, fails to show their relevancy to a bankruptcy situation. See Petitioner's Brief at p. 20. Importantly, it is worth noting that the primary purpose of the preference provisions is to provide *equality* among creditors and to require disgorgement of amounts received by one creditor for its exclusive benefit and to the detriment of other similarly situated creditors. In such settings, it is also important to note that where a creditor provides value in exchange for the payments received, perhaps a debtor's slide into bankruptcy is minimized. Turning to the facts of the case at bar, it becomes evident that the $7 million loan by Petitioner, Union Bank, to ZBest, was not an ordinary transaction. Rather, it was an extraordinary transaction. The funds were provided in December, 1986, seven months prior to the date upon which ZBest filed for protection from creditors. All funds provided by Petitioner, Union Bank, were dissipated by ZBest in its fraudulent business operation. To

that extent, the payments of monthly interest accruals (which Petitioner alleges to be ordinary payments) could not possibly have provided any benefit to the estate other than to merely hold off the Petitioner from seeking to enforce its provisions of default under its loan agreement. Petitioner can point to *no* benefit to ZBest resulting from the preferential payments made allegedly in ZBest's ordinary course of business.

In addition, the Ninth Circuit did not rule upon the issue of whether or not the existence of the ZBest's fraudulent operation eliminates the availability of the ordinary course of business exception to a creditor since one engaging in such an activity cannot be said to be engaging in an "ordinary" business.

This Court should not be asked to rewrite a statute. Respondent opines that statute writing is best left to the legislative branch which, if Petitioner believes does not correctly set forth a predominant test, should be addressed by additional legislation.

ARGUMENTS OF RESPONDENT

I. CONGRESSIONAL AMENDMENTS TO § 547(c)(2) UNDER THE 1984 ACT WERE NOT INTENDED TO PROTECT PAYMENTS ON LONG-TERM DEBT OBLIGATIONS FROM A TRUSTEE'S PREFERENCE AVOIDING POWERS.

As a result of perceived unfairness to trade creditors and issuers of commercial paper through the strict application of § 547, Congress considered numerous bills proposing changes to § 547(c).[2] The end result was the passage of the 1984 amendments. Several specific problems involving trade debt, commercial paper, and consumer debt had been encountered in the application of § 547 and led to two significant changes to the § 547(c)(2)'s requirement that the payment to the creditor be made within forty-five days of the date the debt was incurred.[3] Second, Congress added a new exception, § 547

---

[2] *See* H.R. 5148, 98th Cong., 2d Sess. (1984); H.R. 1800, 98th Cong., 1st Sess. (1983); S. Rep. No. 445, 98th Cong., 1st Sess. (1983); H.R. 1169, 98th Cong., 1st Sess. (1983); H.R. 1147, 98th Cong., 1st Sess. (1983); H.R. 1085, 98th Cong., 1st Sess. (1983); S. Rep. No. 2000, 97th Cong., 2d Sess. (1982); S. Rep. No. 2000, 97th Cong., 1st Sess. (1981); H.R. 4786, 97th Cong., 1st Sess. (1981); S. Rep. No. 863, 97th Cong., 1st Sess. (1981); H.R. 3705, 97th Cong., 1st Sess. (1981); S. Rep. No. 3259, 96th Cong., 2d Sess. (1980); S. Rep. No. 3023, 96th Cong., 2d Sses. (1980); H.R. 5447, 96th Cong., 1st Sess. (1979); S. Rep. No. 658, 96th Cong., 1st Sess. (1979). Broome, *Payments on Long-Term Debt as Voidable Preference: The Impact of the 1984 Bankruptcy Amendments*, 1987 Duke Law Journal 78 (1987) (hereinafter referred to as "Broome").

Many of the proposals were designed to correct technical problems and unintended consequences of some of the changes made by the 1978 Code. *See, e.g.*, S. Rep. No. 305, 96th Cong., 1st Sess. 2 (1979).

[3] Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333, 378 (1984). Broome, *see supra* note 2, at 100.

(c)(7), for small dollar amount transfers made by consumer debtors.[4]

The complaints made to Congress regarding the elimination of the forty-five day period were lodged primarily by trade creditors, commercial paper issuers, and consumer lenders.[5] Trade creditors complained that many normal trade payments by a business debtor were avoidable, in the absence of the reasonable cause to believe requirement, and were in many instances not saved from preferential avoidance by the forty-five day rule in § 547 (c)(2). Significantly, Congress did not hear from long-term business creditors; they did not complain about the operation of the 1978 Code because most long-term business loans are secured.[6]

The most critical factor considered by Congress in eliminating the forty-five day requirement was that, contrary to previous assumptions,[7] the forty-five day period between the date of payment and the date of the incurrence of a debt did not comply with the trade credit practices in most industries. Industry groups argued that they had

[4] 11 U.S.C. § 547(c)(7) (Supp. III 1985). Broome, *see supra* note 2, at 100.

[5] The hearing testimony before Congress, *see supra* note 2, related to problems experienced by these groups. Broome, *see supra* note 2, at 100.

[6] *See infra* note 25. *See also* Nimmer, *Security Interests in Bankruptcy: An Overview of Section 547 of the Code*, 17 Hous. L. Rev. 289, 302 (1980).

J. Pringle & R. Harris, Essentials of Managerial Finance 462 (1984); J. Weston & E. Brigham, Essentials of Managerial Finance 272 (7th ed. 1985). Broome, *see supra* note 2, at 100.

[7] The drafters assumed that the 45-day period between the date of payment and the date of the incurrence of a debt was compatible with the trade credit practices in most industries. *Minutes of the Subcomm. on Civil & Constitutional Rights of the House Comm. on the Judiciary*, 95th Cong., 1st Sess. 553 (1977), Mark-up of Minutes of H.R. 6, at 553. Broome, *see supra* note 2, at 101.

normal payment periods of forty-five days or longer[8] and that trade credit periods exceeding forty-five days were common in many seasonal industries including the clothing, toy, and sporting goods industries.[9] However, these considerations are wholly inapplicable to the extension of long-term credit by a bank since the date of the loan governs the date the debt is incurred and, therefore, reference to a "normal trade cycle" with respect to repayment of a long-term debt obligation by a debtor is irrelevant.

To prevent application of a trustee's preference avoiding powers, many short-term trade creditors constructed normal trade credit periods to fit within the protection of § 547(c)(2).[10] It was thought that this distortion of business practices would have one of two effects. Either trade creditors would be unwilling to extend credit for a period longer than forty-five days, causing severe cash flow problems to the buyers and retailers with whom they dealt[11], or, if credit was extended for longer than forty-five days, the trade creditor would demand terms that would compensate it for the increased risk that any payment it received might be avoided and recovered if the debtor subsequently entered a bankruptcy proceeding.[11]

Section 547(c)(2)'s forty-five day requirement was troublesome even in industries with normal trade credit terms of less than forty-five days because debtors encountered considerable difficulty in determining when the

[8] *See 1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 259.

[9] *Id.* at 254 (statement of Irving Sulmeyer, attorney).

[10] *See 1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 248. Fortgang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. Rev. 1148 (1981).

[11] *See 1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 255. Broome, *see supra* note 2, at 101.

[12] *See id.* at 198.

debt was deemed to be incurred[13] and when the payment was deemed to be made.[14] Court decisions demonstrated that the technical application of the forty-five day requirement left payments made to many trade creditors unprotected from avoidance.[15]

Short-term creditors, other than those extending trade credit, also encountered difficulties with the operation of § 547(c)(2). Commercial paper issuers objected to the effect § 547(c)(2) had on the market for commercial paper[16], a short-term, unsecured debt obligation typically issued by large corporations.[17] Absent the "reasonable cause to believe" requirement, if a commercial paper issuer entered a bankruptcy proceeding within ninety days after repaying a purchaser, the payment would be a preferential transfer and the purchaser might be required to remit the payment as an avoidable preference.[18]

[13] The determination of the date on which the debt is incurred has proved difficult for many courts. *See, e.g.*, Nolden v. Van Dyke Seed Co. (*In re Gold Coast Seed Co.*), 751 F.2d 1118, 1119 (9th Cir. 1985).

Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Code*, 17 U. Rich. L. Rev. 667, 681 (1983).

[14] *See* Herbert, *supra* note 13, at 689.

[15] *See, e.g.*, Grogan v. Liberty National Life Insurance Co. (*In re* Advance Glove Manufacturing Co.), 761 F.2d 249, 252 (6th Cir. 1985) (payments for insurance premiums avoided because not made within 45 days of due date).

[16] *See Hearings on S. Rep. No. 3023*, *supra* note 2, at 8-17.

[17] A purchaser, often an institutional investor, buys the issuer's commercial paper for cash in return for the issuer's promise to repay the cash, plus interest, at a fixed time in the future. Commercial paper is necessarily a short-term debt; maturities of commercial paper issues are limited to less than 270 days to avoid registration with the Securities and Exchange Commission. *See Hearings on S. Rep. No. 3023*, *supra* note 2, at 13.

[18] *Hearings on S. 3023*, *supra* note 2, at 14.

The only way a purchaser could be assured that the payment would not be avoided was to purchase commercial paper with a maturity of less than forty-five days. The result under the 1978 Bankruptcy Code was an artificial shortening of the maturities of commercial paper from as much as 270 days to less than forty-five days" and a decrease in access to the commercial paper market for companies that did not want to issue commercial paper for such a short term.[20]

A further problem noted during this period was the avoidance of preferential payments made by consumer debtors. Section 547(c)(2) excepted a payment by a consumer debtor from avoidance only if the payment was made and the debt was incurred in the "ordinary course of . . . financial affairs of the debtor and the transferee," and the payment was made according to ordinary business terms, and within forty-five days of the date the debt was incurred.[21] Creditors complained that regular payments received from consumer debtors on long-term installment obligations were avoidable even though the creditors may not have had reasonable cause to believe that the debtor was insolvent. Some creditors receiving payments from consumer debtors on long-term installment obligations attempted to assert entitlement to § 547(c)(2)'s protection by arguing that the date the debt was "incurred," i.e., the date the forty-five day period began to run, was the date the loan payment was due. The United States Court of Appeals for the Seventh Circuit rejected this argument

[19] *See Hearings on S. 3023*, *supra* note 2, at 14. *See also* Fortgang & King, *supra* note 10, at 1170 ("[Section 547(c)(2)] functions to require a period of maturity that in many instances may be unrealistic."). Broome, *supra* note 2, at 104.

[20] *See Hearings on S. Rep. No. 3023*, *supra* note 2, at 15.

[21] 11 U.S.C. § 547(c)(2) (1982), *amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333, 378.

in *Barash v. Public Finance Corp.*[22] and held that regular installment payments by consumer debtors to undersecured creditors were avoidable as preferences because the debt for the principal amount of the loan was incurred on the date of the loan, rather than on the date each installment was due.[23] Most courts[24] and legal commentators[25] agree with this result.

Following the holding in *Barash* that a consumer debt was incurred when the loan funds were advanced, creditors next took up the argument that payments made by business debtors for the interest portion of a long-term debt were protected by the forty-five day exception because the debt for interest was incurred each day as the

[22] 658 F.2d 504 (7th Cir. 1981). *See also, Energy Cooperative, Inc. v. Socap International, Ltd.*, 832 F.2d 997, at 1004 (7th Cir. 1987) in which the Seventh Circuit Court citing *Barash* again found that § 547(c)(2) "protects 'ordinary trade credit transactions that are kept current.'"

[23] *Id.* at 512.

[24] *See, e.g., Wickham v. United American Bank (In re Property Leasing & Management, Inc.)*, 46 Bankr. 903, 913-14 (Bankr. E.D. Tenn. 1985); *Tidwell v. Merchants & Farmers Bank (In re Dempster)*, 59 Bankr. 453, 459 (Bankr. M.D. Ga. 1984); *Pippin v. John Deere Co. (In re Pippin)*, 46 Bankr. 281, 283-284 (Bankr. W.D. La. 1984); *Rabin v. Equibank (In re Faller)*, 42 Bankr. 593, 594-95 (Bankr. N.D. Ohio 1984); *Schmitt v. Equibank (In re R.A. Beck Builder, Inc.)*, 34 Bankr. 888, 892 (Bankr. W.D. Pa. 1983); *Sanborn v. Bangor Federal Credit Union (In re Sanborn)*, 29 Bankr. 655, 657-58 (Bankr. D. Me. 1983); *Grant v. Blazer Financial Service (In re Head)*, 26 Bankr. 578, 580 (Bankr. M.D. Fla. 1983).

[25] *See, e.g.*, D. Baird & T. Jackson, *Case, Problems and Materials on Bankruptcy*, 317 (1985); 4 Collier on Bankruptcy ¶ 547.38, at 547-125 (15th ed. 1985); P. Murphy, Creditor's Rights in Bankruptcy § 10.15 (Supp. 1985); Anderson, *In re Iowa Premium Service Co.: When is a Debt Incurred Under 547(c)(2) of the Bankruptcy Code*, 17 Creighton L. Rev. 1075 (1984); Ward & Shulman, *In defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 Wash. U.L.Q. 1, 19 (1983).

interest accrued. The United States Court of Appeals for the Eighth Circuit sitting *en banc* accepted this argument in *Iowa Premium Service Co. v. First National Bank of St. Louis (In re Iowa Premium Service Co.)*,[26] but the decision has not been uniformly followed outside the Eighth Circuit and, therefore, must be strictly limited to the facts and stipulations reached in that decision.[27]

Consumer creditors also asserted that avoiding payments made by consumer debtors on long-term installment obligations did not further equality of distribution of the debtor's estate because the additional sums recovered by the trustee were usually sufficient only to offset the administrative expenses associated with recovery.[28] The net result was that the debtor's estate was not enhanced for the benefit of the creditors.[29]

In addition to the proposal to eliminate the forty-five day requirement,[30] numerous other remedies were pro-

[26] 695 F.2d 1109, 1112 (8th Cir. 1982) (en banc). Significantly, the parties stipulated that the bank creditor's demand note was incurred in the ordinary course of the debtor's and creditor's businesses. *Id.* at 11. *See also Lang v. Advance Loan Co. (In re Graves)*, 45 Bankr. 858, 860 (E.D. Cal. 1985). *See also* American Bar Association Committee on Developments in Business Financing, *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 Bus. Law. 1645, 1649 (1980).

[27] *See, e.g., Lingley v. Stuart Shaines, Inc. (In re Acme-Dunham Inc.)*, 50 Bankr. 734, 741 (D. Me. 1985) (obligation to pay interest "arises when the debtor gets a property interest in the consideration exchanged" in loan transaction).

[28] *See* S. Rep. No. 65, *supra* note 9, at 14 ("[T]he administrative expense of these collections, particularly in individual proceedings, results in very little being distributed to creditors."); S. Rep. No. 446, 97th Cong., 2d Sess. 24 (1982) (same).

[29] *See* 1981 *Hearings on Bankruptcy Reform Act*, *supra* note 2, at 69 ("By definition, ordinary course payments do not involve creditor pressure of a type which is deterred by the preference section."). Broome, *see supra* note 2, at 107 fn. 128.

[30] S. Rep. 445, 98th Cong., 1st Sess. § 211(b) (1983). The explanation for this change was that the 45-day limitation "places undue

posed, debated and reviewed to resolve the perceived unfairness resulting from the strict application of the preference powers of § 547.[31] In 1981[32], 1982[33] and 1983[34] bills were introduced to reinsert the "reasonable cause to believe" requirement as an element of a preferential transfer under § 547(b). Reinsertion of this requirement would have largely eliminated the alleged problems with the application of the preference provisions because most trade creditors, commercial paper issuers, and consumer lenders would not have reasonable cause to believe the debtor was insolvent.[35] Finally, reinserting the "reasonable cause to believe" requirement into § 547(b) would also serve to protect from avoidance payments to creditors

burdens upon creditors who receive payment under business contracts providing for billing cycles greater than 45 days." S. Rep. No. 65, *supra* note 9, at 60.

[31] It was also suggested that section 547(c)(2) be amended to provide that a payment be excepted from avoidance if made shortly after the date the debt was due.

[32] S. Rep. No. 2000, 97th Cong., 1st Sess. § 10 (1981); H.R. 4786, 97th Cong., 1st Sess. § 11 (1981).

[33] S. Rep. No. 2000, 97th Cong., 2d Sess. § 11 (1982).

[34] H.R. 1800, 98th Cong., 1st Sess. § 111 (1983); S. Rep. No. 445, 98th Cong., 1st Sess. § 211(a) (1983); H.R. 1169, 98th Cong., 1st Sess. § 11 (1983); H.R. 1085, 98th Cong., 1st Sess. § 11 (1983).

[35] The 1898 Act did not draw a distinction between the avoidability of preferential payments on short-term debt and the avoidability of ~~preferential~~ payments on long-term debt, although as a general matter payments on short-term debt were less likely to be found avoidable. In most cases a timely payment on short-term debt, such as trade credit, was not avoidable because a trade creditor was unlikely to have reasonable cause to believe that the debtor was insolvent. See Dunham & Price, *The End of Preference Liability for Unsecured Creditors: New Section 547(c)(2) of the Bankruptcy Code*, 60 Ind. L.J. 487, 493 (1985). Trade credit is short-term credit extended by a seller in connection with the sale of goods or the provision of services. *See* Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, at 769 (1985). Broome, *see supra* note 2, at 107, fn. 134.

on long-term debt, made after the expiration of the protected forty-five day period, if the trustee was unable to prove that the creditor had reasonable cause to believe the debtor was insolvent at the time of the payment.[36]

As a result of pressure asserted by lobbying groups upon Congress with respect to issuers of short-term commercial paper, Congress considered the adoption of changes to § 547(c)(2) which would protect commercial paper purchasers from application of the trustee's avoidance powers.[37] A special exception for payments made by a commercial paper issuer to the purchaser was proposed.[38] The National Bankruptcy Conference objected to this "piecemeal" approach to the problems created by the 1978 Code's radical revision of the preference provision.[39]

The third proposal addressed the problems expressed by consumer installment lenders. It proposed an exception that would insulate a payment from preferential avoidance if the aggregate value of all property constituting or affected by such transfer was less than $250 in a Chapter 7 or Chapter 13 case or less the $750 in a Chapter 11 case.[40] A modified version of this proposal, the current § 547(c)(7), was contained in H.R. 5174, the bill that was eventually passed as the 1984 Amendments.[41]

The culmination of the discussions regarding possible modification of § 547, as it was enacted in the 1978 Code,

[36] *See Farmers Bank v. Julian*, 383 F.2d 314, 326 (8th Cir. 1967). Broome, *see supra* note 2, at 108, fn. 135.

[37] H.R. 5148, 98th Cong., 2d Sess. (1984); S. 445, 98th Cong., 1st Sess. (1983); S. Rep. No. 3023, 96th Cong., 2d Sess. (1980).

[38] H.R. 5148, 98th Cong., 2d Sess. (1984).

[39] *1981 Hearings on Bankruptcy Reform Act*, *supra* note 2, at 250.

[40] H.R. 1147, 98th Cong., 1st Sess. § 9 (1983).

[41] Cyr, *Setting the Record Straight for a Comprehensive Revision of the Bankruptcy Act of 1898*, 49 Am. Bankr. L.J. 99, 166 n.242 (1975).

was H.R. 5174.[42] H.R. 5174 proposed only one change to § 547(c): the introduction of § 547(c)(7), relating to payments by consumer debtors.[43] The bill was hastily considered in the House because of the urgency of the jurisdictional crisis facing the bankruptcy court system[44] and was passed by the House after the jurisdictional provisions of the bill were amended.[45]

The Senate then began consideration of the bill. Senator Thurmond introduced an amendment in the nature of a substitute for the bill passed in the House.[46] Senator Thurmond noted that although portions of his amendment were not included in the House bill, the changes did "have broad support in the Senate."[47] The amendment contained four distinct provisions affecting the preference provision of the 1978 Code and addressing problems with its operation that had previously been considered by the House and Senate. First, Senator Thurmond proposed to amend § 547(b) to reinsert the "reasonable cause to believe" requirement as an element of a preferential transfer.[48] This proposal was withdrawn by Senator Thurmond prior to the amendment's passage in the Senate,[49] however, apparently in order to gain Senator Met-

[42] H.R. 5174, 98th Cong., 2d Sess. (1984).

[43] *Id.*

[44] *See supra* note 3. The procedural posture of the bill prevented consideration of more than one amendment, 130 Cong. Rec. H1796 (daily ed. Mar. 21, 1984), although this limitation was controversial.

[45] *Id.* at H1854.

[46] *Id.* at S6081 (daily ed. May 21, 1984). The text of the amendment (No. 3083) is set forth *id.* at S6107-27.

[47] *Id.*, at S6083. Broome, *see supra* note 2, at 109, fn. 146.

[48] *Id.* at S6122. This suggestion had been previously considered in Congress. *See supra* notes 32-34 and accompanying text. Broome, *see supra* note 2, at 110, fn. 147.

[49] *Id.* at S7617 (daily ed. June 19, 1984).

zenbaum's support for the remainder of Senator Thurmond's proposals.[50]

The second proposed change to § 547 involved amending § 547(c)(2) to remove the forty-five day requirement.[51] This change had previously been endorsed by the Senate when it passed S. Rep. No. 445 in 1983.[52] The Senate Report accompanying that bill explained that the change was necessary because the forty-five day limitation "places undue burdens upon creditors who receive payment under business contracts providing for billing cycles greater than 45 days.[53]

A third proposal involved adding § 547(c)(8) to protect payments to commercial paper purchasers from avoidance,[54] but this proposal was also withdrawn prior to the amendment's passage.[55] One possible explanation for the withdrawal of proposed § 547(c)(8) is that elimination of the forty-five day provision from § 547(c)(2) resolved the commercial paper problem and made a special section

[50] *Id.* (statement of Sen. Thurmond).

[51] *Id.* at S6122 (daily ed. May 21, 1984)..

[52] *Id.* at S5388 (daily ed. Apr. 27, 1983).

[53] S. Rep. No. 65, *supra* note 9, at 60. Broome, *see supra* note 2, at 110, fn. 152.

[54] Senator Thurmond's amendment added a new subparagraph (8), under which the trustee could not avoid a transfer to or for the benefit of a creditor to the extent such transfer was made to such creditor by a credit guarantor in payment of a debt evidenced by a note or bond issued by the debtor prior to the commencement of the case and in accordance with the terms of the debtor's credit guaranty agreement with the credit guarantor, and payment of which was supported from time of its issuance until such transfer by an irrevocable letter of credit, irrevocable commitment to lend funds, irrevocable note purchase agreement, or a bond of indemnity issued by a credit guarantor in the ordinary course of its business. *Id.* at S6127 (daily ed. May 21, 1984).

[55] *See* Countryman, *supra* note 35, at 772. Broome, *see supra* note 2, at 110, fn. 154.

protecting payments to commercial paper purchasers unnecessary.[56] However, it is clear that the Senate debate surrounding the issue of commercial paper focused on short-term commercial obligations and not long-term debt.

The final section of Senator Thurmond's amendment affecting § 547(c) was the addition of § 547(c)(7) to protect certain payments be consumer debtors from preferential avoidance.[57] The proposed addition was identical to that already approved in the House version of H.R. 5174. The Senate passed H.R. 5174,[58] as changed by Senator Thurmond's amendment, adding § 547(c)(7) to the 1978 Code to protect some payments by consumer debtors from avoidance and eliminating the forty-five day provision from § 547(c)(2).

The Senate insisted on its version of the bill and asked for a conference with the House.[59] The House agreed to the conference and the conference report was submitted on June 29, 1984.[60] The report did not include a joint explanatory statement of the bill, but only the text of the

[56] A discussion on the Senate floor between Senators Dole and DeConcini regarding the Conference Report on the bill indicates that they believed that the elimination of the 45-day requirement would "relieve buyers of commercial paper with maturities in excess of 45 days of the concern that repayments of such paper at maturity might be considered as preferential transfers," and that "companies that have a need for short-term funds, and investors who wish to purchase short-term obligations, would both be acting in their respective 'ordinary course cf business or financial affairs'" in dealing with each other in the commercial paper market. 130 Cong. Rec. S8897 (daily ed. June 29, 1984, pt. II). *See also* Dunham & Price, *supra* note 35, at 497-99. Broome, *see supra* note 2, at 110, fn. 155.

[57] 130 Cong. Rec. S6114 (daily ed. May 21, 1984).

[58] *Id.* at S7625 (daily ed. June 19, 1984).

[59] *Id.*

[60] H.R. Conf. Rep. No. 882, 98th Cong., 2d Sess., *reprinted in* 1984 U.S. Code Cong. & Admin. News 576.

bill as agreed to in conference. The conference version of the bill was identical to the version passed by the Senate as it related to § 547.[61] The conference bill was accepted by both the Senate and the House [62] and signed by the President.

The end result of all bills, discussions, decisions and debates was the final changes made by the 1984 Amendments to the preference provision which Respondent asserts were made merely in response to particular concerns of various creditor groups. Removal of the forty-five day provision responded to problems encountered by trade creditors [63] and commercial paper purchasers [64] who asserted that the arbitrary forty-five day limitation was not consistent with regular short-term extensions of credit and resulted in the distortion of normal business practices to fit within the exception. Further, the addition of § 547(c)(7) to protect certain small dollar amount transfers by consumer debtors responded to the problems encountered by lenders to consumers following elimination of the "reasonable cause to believe" requirement.[65]

It is the position of the Petitioner that removal of the forty-five day provision from the ordinary course of business exception should be read as extending the preference powers exception's protection to payments on long-term debt because the legislative history contains no express statement which limits § 547(c)(2) to short-term debt [Petitioner's Brief at p. 10]. One commentator has agreed

[61] 130 Cong. Rec. S8887 (daily ed June 29, 1984, pt. II) (statement of Sen. Thurmond); *id.* at H7489 (daily ed. June 29, 1984, pt. I) (statement of Rep. Rodino).

[62] *Id.* at S8900, H7500 (daily ed. June 29, 1984, pt. II).

[63] *See supra* text accompanying notes 7-15

[64] *See supra* text accompanying notes 16-20.

[65] *See supra* text accompanying notes 21-25. Broome, *see supra* note 2, at 111, fn. 164.

with this position.[66] However, Respondent urges this Court to recognize that a contrary inference seems more persuasive—that is, the absence of any clear indication that Congress intended to expand § 547(c)(2) protection to long-term debt justifies an inference that there was *no* such intent. Furthermore, because *no* creditors complained during the hearings conducted on the operation of the 1978 Code that the avoidance of payments on long-term debt by business debtors was unfair,[67] it is unlikely that Congress considered the avoidability of such payments a problem that it should address. Nor is there any indication that Congress intended, by eliminating the forty-five day requirement, to narrow the chief objective of the preference provision from that of preserving equality of distribution to that of preventing inequality resulting from impermissible creditor pressure applied by a creditor hoping to obtain more favorable treatment than it would otherwise receive in the debtor's bankruptcy proceeding. The most obvious indication that Congress did not wish to return to a concept of avoiding only those payments that might be the result of creditor pressures was its decision not to return to the "reasonable cause to believe" requirement as an element of a preferential transfer. Long-term creditors lost the protection of the "reasonable cause to believe" requirement as a result of a deliberate policy choice by Congress in the 1978 Code. It appears unreasonable to suggest that Congress intended to overturn that choice in the 1984 Amendments without significant discussion,[68] particularly when the discussion

---

[66] DeSimone, *Section 547(c)(2) of the Bankruptcy Code: The Ordinary Course of Business Exception Without the 45-Day Rule*, 20 Akron L. Rev. 95, 129 (1986).

[67] *See supra* note 6 and accompanying text. Broome, *see supra* note 2, at 112, fn. 166.

[68] *See Aguillard v. Bank of Lafayette (In re Bourgeois)*, 58 Bankr. 657, 659-60 (Bankr. W.D. La. 1986). Broome, *see supra* note 2, at 112, fn. 167.

that did accompany the amendment of § 547(c)(2) is consistent with interpreting the section to protect only short-term debt.

While Petitioner may attempt to persuade this Court that a different conclusion is warranted, Petitioner's "call to arms" must fall upon deaf ears since Petitioner can point to *no* Congressional history which demonstrates that Congress intended a radical departure from the general principles of preference law enacted under the 1978 Code. More importantly, the Congressional confusion over which changes to make to the 1978 Code, coupled with the fact that most desired changes did not become part of the 1984 Amendments only serves to further support the position urged by Respondent; Congressional Amendments to § 547(c) under the 1984 Act were not intended to protect payments on long-term debt obligations from a trustee's preference avoiding powers. If the primary goal intended by Congress in its enactment of § 547 under the 1978 Code was to insure equality of distribution amongst the creditors of a bankrupt's estate then, the spirit and quality of these preference powers granted a trustee can only be meaningful if not emasculated by exceptions to the rule. A determination by this Court that Congressional changes to § 547(c) under the 1984 Amendment were primarily concerned with short-term credit facilities and the protection of persons receiving payments in consideration of such short-term credit extensions would serve to protect and preserve the preference powers vested by Congress in a trustee. Enlarging the exception to include payments on long-term debt would only defeat the primary objective: Equality of Distribution.

II. PROTECTING PREFERENCE PAYMENTS MADE BY A DEBTOR ON ACCOUNT OF A LONG-TERM DEBT OBLIGATION DOES NOT FURTHER THE POLICY UNDERLYING THE RECOVERY OF PREFERENCES.

The legislative history of the ordinary course of business exception supports Respondent's interpretation and that of the Seventh, Ninth and Eleventh Circuit Courts of Appeals that § 547(c)(2) excludes long-term debt from its coverage. The policies of the preference provision and the ordinary course of business exception supports Respondent's position that the exceptions were intended to be limited and narrowly construed.

The principal objective of the preference provision is to "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor." [69] When a debtor becomes insolvent, a transfer to a creditor whose claim is not fully secured necessarily impairs the claims of the debtor's other unsecured and undersecured creditors.[70] The trustee's power to avoid preferential transfers only partially prevents the resulting unequal treatment of creditors because the power in most cases extends only to transfers made during the ninety day period preceding the filing of the bankruptcy petition and does not reach transfers previously made by an insolvent debtor.[71]

[69] H.R. Rep. No. 595, 95th Cong., 1st Sess. 178 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 Va. L. Rev. 249, 260 (1981). *See also Yellowhouse Machinery Co. v. Mack*, 704 F.2d 820, 822 (5th Cir. 1983) in which the Fifth Circuit Court of Appeals stated: "The nature of the different avoiding powers guaranteed by Section 547 . . . is intended to promote the common good of *all* of an estate's creditors by fostering 'the *prime* bankruptcy policy of equality of distribution among creditors of the debtor'." (Emphasis added)

[70] *See* McCoid, *supra* note 69, at 260.

[71] The trustee is empowered only to avoid preferential transfers made 90 or fewer days before the filing of the bankruptcy petition, § 547(b)(4)(A) (Supp. III 1985), or less than one year before the filing of the petition if the transfer is to an insider. *Id.* § 547(b)(4)(B). Broome, *see supra* note 2, at 113, fn. 170.

It has been suggested that § 547(c)(2), as originally enacted, was justified because it was not inconsistent with the goal of equal distribution. The argument is that payments of short-term debt do not deplete the debtor's estate because the recent extension of credit provides offsetting value to the estate.[72] The court in *Bourgeois* and at least one commentator have relied on this "depletion of the estate" rationale to argue that § 547(c)(2), as amended, should not be read to cover payments on long-term debt.[73] If the transfer of a payment is a preference, the payment, by definition, diminishes the estate that would otherwise be available for all creditors pursuant to § 547(b)(5).[74] This, however, has no bearing upon the true goal: equality of distribution. The equality of distribution goal, however, distinguishes between creditors and noncreditors.[75] Creditors are not treated unequally when a debtor transfers assets in an exchange with a

[72] *See Lingley v. Stuart Shaines, Inc. (In re Acme-Dunham Inc.)*, 50 Bankr. 734, 740 (D. Me. 1985); Herbert, *The Trustee Versus the Trade Creditor II: The 1984 Amendment to Section 547(c)(2) of the Bankruptcy Code*, 2 Bankr. Dev. J. 201, at 217 (1985); Kaye, *Preferences Under the New Bankruptcy Code*, 54 Am. Bankr. L.J. 197 (1980).

[73] *See Aguillard v. Bank of Lafayette (In re Bourgeois)*, 58 Bankr. 657, 660 (Bankr. W.D. La. 1986).

[74] 11 U.S.C. § 547(b)(5) (1982) setse forth as an element of a preferential transfer the requirement that as a result of the transfer the transferee receive more than it would have received in a Chapter 7 proceeding if the transfer had not been made. Thus, "any transfer to a creditor within the 90-day period by way of payment on or security for an antecedent debt causes a depletion of the debtor's estate and, other elements being present, will constitute a voidable preference." 4 Collier on Bankruptcy ¶ 547.20, at 547-83 (15th ed. 1985).

[75] Broome, *see supra* note 2, at 114, fn. 174.

noncreditor. For example, a merchant who sells goods for cash[76] rather than for a claim to a future transfer does not share the risk that the debtor may have insufficient assets to satisfy future claims. In contrast, a creditor shoulders the risk of nonpayment equally with other creditors.

A second objective of the preference provision is to assist the debtor in working its way "out of a difficult financial situation through cooperation with all of his creditors" by discouraging creditors from engaging in the so-called "race ofdiligence."[77] The House and Senate Reports accompanying the 1978 Code reiterate that § 547(c)(2) was designed to "leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section [which is] to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy."[78]

It has also been suggested that § 547(c)(2) should be extended to protect payments on long-term debt because (1) the long-term creditor is not likely to take part in a race to gain advantage over other creditors, and (2) regular payments on long-term debt constitute normal financial relations that should not be disturbed.[79] This assertion, however, is strained for four reasons. First,

[76] A transfer cannot be on account of an antecedent debt if it is made for new value. "New value" is defined to include "money or money's worth in goods." 11 U.S.C. § 547(a)(2) (Supp. III 1985). Of course, the exchange must not be so unequal as to amount to a fraudulent conveyance. *Id.* § 548 (1982 & Supp. III 1985).

[77] H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138.

[78] H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6329; S. Rep. No. 989, 95th Cong., 2d Sess. 88, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5874. Broome, *see supra* note 2, at 115, fn. 17?.

[79] *See supra* note 66 and accompanying text. Broome, *see supra* note 2, at 115, fn. 180.

the legislative history is misleading. After Congress removed the "reasonable cause to believe" requirement in 1978, the main goal of the preference provision was to preserve equality of distribution; the prevention of unusual pressure or action by the creditor became only an incidental objective.[80] Second, and more importantly, there is *no* direct indication that Congress intended to change this policy focus in the 1984 Amendments.[81] Congress rejected returning to the goal of preventing unusual action by declining to reinsert the "reasonable cause to believe" requirement.[82] The elimination of that requirement was one of the most significant and debated changes to the preference provision made by the 1978 Code.[83] It seems unlikely that removal of the forty-five day requirement from § 547(c)(2) was intended to change the focus of the preference provision from equality of distribution to prevention of the race of diligence, especially in the absence of any discussion to that effect.[84]

Third, commentators argue that § 547(c)(2), as amended, protects payments on long-term debt because these payments are within normal financial relations.[85] These commentators rely on the legislative history accompanying the 1978 version of § 547(c)(2).[86] This reli-

[80] H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138.

[81] *See supra* text accompanying note 66.

[82] *See supra* text accompanying notes 32-34, 147-48. Broome, *see supra* note 2, at 116, fn. 183.

[83] *See* D. Baird & T. Jackson, *supra* note 25 at 284. Broome, *see supra* note 2, at 116, fn. 184.

[84] *See supra* note 68. Broome, *see supra* note 2, at 116, fn. 185.

[85] *See supra* note 25. Broome, *see supra* note 2, at 116, fn. 186.

[86] See H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* 1978 U.S. Cong. & Admin. News 5963, 6329; S. Rep. No. 989, 95th Cong., 2d Sess. 88, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5874. Broome, *see supra* note 2, at 116, fn. 187.

ance on the "normal financial relations" concept is misplaced, however, because this phrase refers to payments on debt satisfying the ordinary course of business requirements and made within forty-five days of the date the debt was incurred. Unlike short-term debt, long-term debt is generally not incurred in the "ordinary" course of business, but rather, represents an extraordinary transaction providing for extensive capital funding of a debtor's business operation. Since the statutory provision was specifically limited to short-term debt, it cannot be said that Congress intended "normal financial relations" to encompass payments made on account of an antecedent long-term debt.

Finally, declining to read § 547(c)(2) as extending to payments on long-term debt does not imply a complete rejection of the deterrence objective. Although deterring the race to dismember the debtor is not the major objective of the preference provision, deterrence is recognized in current §§ 547(c)(2)(B) and (C), which require that payments be made (1) in the ordinary course of business of the debtor and the transferee and (2) according to ordinary business terms.[87] A payment compelled by creditor pressure would not be afforded protection from avoidance.

If the ordinary course of business exception is inconsistent with the goal of equality, and if the protection of "normal financial relations" does not define the outer limits of the exception as amended in 1984, the problem of defining the outer limits of the exception remains. The resolution of this problem relates to the reasons behind preventing the race of diligence.[88] Congress intended to deter the race of diligence in order to enable the debtor "to work his way out of a difficult financial situation

[87] 11 U.S.C. § 547(c)(2)(B), (B), (C) (Supp. III 1985). Broome, *see supra* note 2, at 116, fn. 188.

[88] Broome, *see supra* note 2, at 1169.

through cooperation with all of his creditors."[89] This statement indicates that Congress intended to encourage[90] ordinary transactions that may keep the debtor in business.[91] This goal suggests a way to distinguish between debt incurred in the ordinary course of the debtor's business and debt that is not so incurred.[92]

Section 547(c)(2) encourages creditors to extend short-term credit to finance a troubled debtor's current operations. In most instances, a creditor's decision to lend money to a debtor depends on whether the creditor believes the debtor will be able to repay the loan when due and whether the creditor believes the debtor will not enter a bankruptcy proceeding for ninety days thereafter. A short-term creditor evaluating the risk of nonpayment might be fairly confident that the debtor will be able to repay the debt when due from the proceeds of the current operations financed by the debt. On the other hand, a long-term debt lender will normally expect to receive repayment of the obligation owed by a debtor out of the long-term profits generated by a debtor out of its continued business operation. For instance, a creditor extending credit to finance the debtor's purchase of raw materials may view the proceeds arising from later sales of the finished goods as the source of funds to repay the loan. If the short-term creditor believes that the risk of nonpayment is minimal, it must still evaluate the likelihood that the debtor will enter a bankruptcy proceeding

[89] H.R. Rep No. 595, 95th Cong., 1st Sess. 177 1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138.

[90] *See*, Herbert, *supra* note 13, at 670 & n.14. Broome, *see supra* note 2, at 117.

[91] *See* Morrow v. United States (*In re* Morris), 53 Bankr. 190, 192 (Bankr. D. Or. 1985) ("This court believes that the purpose of § 547(c)(2) was to encourage creditors to continue short-term credit dealings with troubled debtors in order to forestall bankruptcy rather than encourage it.").

[92] Broome, *see supra* note 2, at 117.

within ninety days after the payment. If the ordinary course of business exception is not available, then a debtor (especially one experiencing temporary financial difficulty) might be unable to borrow to finance its current operations. In contrast, the extension of § 547(c)(2) to cover payments on long-term debt does not significantly affect the long-term creditor's initial decision to make a loan. For example, suppose the creditor contemplates a one-year loan to be repaid in monthly installments. Interpreting § 547(c)(2) to extend to payments on long-term debt only affords protection for ninety days of payments received at the end of a twelve month payback period. Protecting these payments from avoidance will not significantly alter the creditor's risk of the debtor's insolvency, and thus offers little inducement to a creditor to extend long-term debt.[93]

In addition, preserving the trustee's ability to avoid payments to a long-term creditor may further the goal of preventing the debtor's bankruptcy.[94] Suppose a debtor is unable to meet all of its financial obligations, including a regularly scheduled payment to a long-term creditor, and asks the long-term creditor for an extension so that it may meet its obligations to suppliers with whom it must deal to continue its operations. If § 547(c)(2) protects any regular payment received by the long-term creditor from avoidance, the creditor may insist on its regular payment knowing that it will not be avoidable if the debtor enters bankruptcy within the following ninety days. If § 547(c)(2) does not protect regular payments on long-term debt from avoidance, the creditor has an incentive to work with the debtor so that the debtor may overcome its temporary financial difficulties, stay out of bankruptcy, and eventually meet all of its obligations in full.

---

[93] Broome, *see supra* note 2, at 117.

[94] *See supra* notes 90-92 and accompanying text. Broome, *see supra* note 2, at 118 fn. 192.

Thus, the goal of encouraging creditors to deal with the debtor suggests a way to distinguish between debt incurred in the ordinary course of the debtor's business and debt that is not so incurred.[95] This distinction, as suggested above, may depend on whether the debt is short-term or long-term because the extension of short-term credit is necessary for the continuing operations of the debtor. Even if it is possible to distinguish between short-term and long-term debt, Respondent argues that § 547(c)(2) should be read even more narrowly to include only trade credit.[96]

The legislative history of the ordinary course of business exception indicates that Congress intended the exception to comprehend payments to trade creditors.[97] There are also indications that Congress assumed that short-term commercial paper could be issued in the ordinary course of a debtor's business. Congress conducted hearings on problems experienced by commercial paper issuers under the 1978 Code.[98] The focus of the discussion was *not* whether commercial paper could be issued in the ordinary course of a debtor's business, but whether the maturities of commercial paper issues had been artificially limited by § 547(c)(2) to less than forty-five days.[99] Moreover, when the forty-five day provision was removed in 1984, Senators Dole and DeConcini asserted that "companies that have a need for *short-term funds*,

---

[95] *See* Countryman, *supra* note 35, at 775-75. Broome, *see supra* note 2, at 118, fn. 193.

[96] *See Aguillard v. Bank of Lafayette* (*In re* Bourgeois), 58 Bankr. 567, 660 (Bankr. W.D. La. 1986) (suggesting that section 547(c)(2) "was intended to apply to trade credit transactions" rather than long-term debt).

[97] *See supra* text accompanying note 7.

[98] *See supra* text accompanying notes 16-18. Broome, *see supra* note 2, at 121, fn. 203.

[99] *See supra* note 19 and accompanying text.

and investors who wish to purchase ***short-term obligations***, would both be acting in their respective 'ordinary course of business or financial affairs' if they were to deal directly or indirectly with each other in the commercial paper market."[100] Respondent asserts that short-term debt and not long-term debt from banks or other financial institutions is the focus of attention and protection as can be gleaned from all discussions pertaining to the 1984 Amendments.

Congressional changes made to § 547(c)(2) all focused on the need of a debtor to obtain *short-term* credit to allow it to operate its busines during difficult times. To protect persons who continued to assist the debtor through difficult times by extending *short-term* credit to it, Congress eliminated an artificial 45-day rule and established a facts and circumstance test. However, Congress did *not* deviate from its original goal of preference avoiding powers; the equality of distribution amongst creditors. Surely, Congress did not intend a lender who receives a payment on a long-term debt to benefit more than an unpaid short-term creditor who was not so lucky to receive a payment prior to the debtor's slide into bankruptcy. Of course it did *not*! The only method to promote equality of distribution amongst unsecured creditors is to require disgorgement of preference payments on long-term debts received within 90 days of the debtor's filing of its bankruptcy petition.

More importantly, an anomaly would surely result if a long-term lender received a repayment of the principal amount of its obligation during the 90-day period prior to the debtor's filing for bankruptcy and the short-term creditor received nothing. Can Petitioner seriously argue that the repayment of the principal balance of a long-term loan is likewise excepted from the trustee's avoiding powers through the application of § 547(c)(2)? Re-

[100] 130 Cong. Rec. S8897 (daily ed. June 29, 1984, pt. II) (statement of Sen. DeConcini) (emphasis added). See supra note 56.

spondent thinks not. Equality of distribution means equality amongst creditors. This is best accomplished by narrowing the exceptions to a preference recovery and not by further expansion. Respondent opines that protecting preference payments made by a debtor on a long-term debt obligation does not further the first and foremost policy goal underlying the recovery of preferences: Equality of Distribution.

III. THE *ZBEST* DECISION IS IN CONFORMITY WITH THE LEGISLATIVE AND JUDICIAL HISTORY OF THE PREFERENCE STATUTE.

Petitioner, Union Bank, argues that the decision of the Ninth Circuit does not comport to the clear and plain language of the statute. Petitioner's Brief at p. 11. Petitioner bases this argument upon amendments made to the statute in 1984 pursuant to which the 45-day limitation was deleted. The decision of the Ninth Circuit is *not* contrary to the legislative policy and judicial interpretation of the statute enacted under the 1978 Code. Other circuit courts which have ruled upon the applicability of § 547(c)(2) to protect preferential payments, as most notable *Marathon Oil Co. v. Flatau (In re Craig Oil Co.)*, 785 F.2d 1563 (11th Cir. 1986), have reached the same conclusions as those reached by the Ninth Circuit. Specifically, in the Eleventh Circuit Court of Appeals decision, a "trade" creditor sought to avoid attack by the Chapter 11 trustee to recover payments made by a debtor as a preference under the provisions of § 547(b). As the Eleventh Circuit noted at page 1567:

> "As several courts have noted, this exception is directed primarily to ordinary trade credit transactions. These typically involve some extension of credit that are meant to be paid in full within a single billing cycle . . . Because the credit extended is meant to be extremely short term, Congress likened payment of trade credit to payment of current expenses. Recognizing that the latter had tradition-

> ally been protected from avoidance in bankruptcy, Congress insisted on the same protection to trade credit through the ordinary course of business provision . . . Since the foundation of this provision is the similarity of trade credit and current expense rule, the scope of its protection is necessarily limited to trade credit which is 'kept current' or other transactions which are paid in full within the initial billing cycle." [101]

It is interesting to note that the Eleventh Circuit in the *Marathon* decision cites the Seventh Circuit decision of *Barash v. Public Finance Corp., supra*, which coincides with the jurisdiction presiding over the *Levit v. Ingersol Rand Financial Corp.* 824 F.2d 1186 (7th Cir. 1986) [hereinafter referred to as "*Deprizio*"] decision cited in Petitioner's Brief at p. 4. In *Deprizio*, the Seventh Circuit did not overrule the *Barash* decision, nor was that decision ever discussed. More importantly, the *Deprizio* court, at page 1199 specifically stated that:

> "We need not decide whether installment payments before 1984 may be recovered even though made within forty-five days of their due date, because this appeal does not present for decision the trustee's effort to recoup any particular transfer. It is enough to observe that § 547(b)(5) and (c), both *before and after amendment* exclude from recovery the bulk of ordinary commercial payments." [Emphasis Added]

---

[101] As the Eleventh Circuit pointed out in its decision at Footnote No. 8 at page 1567, 'it was for this reason that Congress originally required payment within forty-five days of incuring the obligation. This period represents a normal trade cycle.' Furthermore, Petitioner notes that there *may* also be a conflict with the Eighth Circuit based upon *Iowa Premium Service Co., Inc., supra* note 26. However, Petitioner's argument is misplaced since the parties thereto *stipulated* to the fact that the ordinary course of business exception applied and that the only issue was the date upon which the debt was incurred. As such, *Iowa Premium Service Co., Inc.* is completely inapplicable to the case at bar.

As pointed out, Respondent urges this Court to note that the Seventh Circuit did not reverse the *Barash* decision which supports the finding by the Ninth Circuit in its *CHG* and *ZBest* opinions, respectively, and more so, that the *Deprizio decision* does not go directly to the merits of the case at bar. More importantly, the *Deprizio court noted* no distinction to the protection provided by § 547(c)(2) prior to and after the 1984 Amendments. As such, the *Deprizio* decision is inappropriate for consideration in the case at bar. More importantly, the Eleventh and Seventh Circuit decisions in *Marathon* and *Barash*, respectively, supports the holding by the Ninth Circuit in *ZBest*.

What the Seventh Circuit, Ninth Circuit and Eleventh Circuits, respectively, have recognized is that the scope and purpose of § 547(c)(2) was not changed by the mere deletion of a forty-five day artificial rule but instead, attention must be focused upon the value derived by a debtor in exchange for the payments being made and fostering the primary goal of equality of distribution. It is, of course, this presumption that enables short-term trade creditors to avoid attack by a trustee seeking to recover alleged preference payments when the value received by the debtor in exchange for the payments have allowed the debtor to continue to operate its business. In the case at bar, the funds were drawn down by *ZBest* over seven months prior to its filing for protection from creditors. The continued payments of interest did not serve to enhance the business of ZBest but merely prolonged the fraudulent business enterprise by taking under its umbrella additional victims.

IV. WHERE THE STATUTE IS UNCLEAR ON ITS FACE, THE INTENTION OF THE DRAFTERS SHOULD GOVERN.

In *United States v. Ron Pair Enterprises, Inc.* 489 U.S. 235 (1989), this Court found the statutory language of § 506(b) to be clear on its face and, therefore, this Court enforced said provisions according to its terms. Nevertheless, this Court was quick to note, at 1031, that:

> "The plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters . . . In such cases, the intention of the drafters, rather than the strict language, controls." (Citations omitted.)

The case at bar is not only one of those "rare" cases but more importantly, it is of exceptional importance to the bankruptcy bar. Petitioner would have this Court believe that the amendments to § 547(c)(2) in 1984, evidenced a Congressional intent to include long-term debt within the statutory exceptions to a trustee's avoiding power. However, this Congressional intent is far from clear.[102] As suggested by one leading commentator, the best future

[102] In *WJM, Inc. v. Massachusetts Dept. of Public Welfare* 840 F.2d 996, 1010 (1st Cir. 1988), the First Circuit Court of Appeals noted that "several Bankruptcy Courts have lamented Congress' failure to flesh out its concept of the 'ordinary' under this section." The First Circuit cited *In re Magic Circle Energy Corp.*, 64 Bankr. 269, 272 (Bkrtcy. W.D. Okl. 1986) for this latter proposition. However, it is worth noting the *Magic Circle* court, at 273, quite clearly stated its recognition that § 547(c)(2) excludes from its protection payments on long-term debt by stating that "while we can concur in the proposition that *there exists a distinction between a long-term loan and an ordinary credit transaction*, we do not believe that such dissimilitude is pertinent to the matter at bar." [Emphasis Added.] Respondent opines that given the First Circuit's adoption of the *Magic Circle* decision that it would likewise concur with the finding that § 547(c)(2) is not applicable to payments made on account of long-term debts.

for § 547(c)(2) is repeal due to the absence of "rational confining limits."[103] Unless legislative intent is clearly demonstrated to *repeal* the substance of preference powers on long-term debt, this Court should be slow to reverse a long-standing rule absent clear and convincing evidence of such an intent.[104]

The judicial interpretation by the Seventh, Ninth and Eleventh Circuits maintains the integrity of the preference powers and is reasonable and consistent with respect to long-term debt. The preferential payments made by ZBest to Petitioner did *not* provide any current benefit (value) to ZBest at the time they were made. There was merely a depletion of ZBest's estate. The proper remedy for depletion is restoration—this is best accomplished by the implementation and utilization of the preference powers to further the goal of Equality of Distribution.

V. THE HOLDING BY THE NINTH CIRCUIT ENFORCES A LONG-STANDING POLICY THAT PAYMENTS ON LONG-TERM OBLIGATIONS SERVE NO BENEFIT TO THE DEBTOR AND MUST BE AVOIDED.

Petitioner points out in its Brief that two policies underlie the preference law, those being:

1. To discourage a "race to the courthouse;" and

2. Dismemberment of the debtor during the debtor's financial decline and to equalize the distribution of assets of the estate among similarly situated creditors.

[103] Countryman, *supra* note 35, at 769.

[104] The Sixth Circuit in *Gosch v. Burns (In re Finn)*, 909 F.2d 903 (6th Cir. 1990) discusses *Ragsdale v. Citizens and Southern National Bank (In re Control Electric, Inc.)*, 91 Bankr. 1010 (Bankr. N.D.Ga. 1988) and disagreed with the general proposition that without legislative history to back it up, a change in the language of the statute is not to be respected. See also, *Waldschmidt v. Ranier (In re Fulghum Construction Corp.)* 872 F.2d 739 (6th Cir. 1989), wherein 547(c)(2) protection was made available to repayments of "short-term" cash advances.

However, Petitioner's argument falls short of demonstrating why its financial arrangement with ZBest and the preferential payments it received merit consideration as being outside the scope of these two policies. Of greater importance is the fact that Petitioner weakly discusses the most important goal of the preference avoiding powers: Equality of Distribution.

Specifically, the transaction between Union Bank and ZBest did not represent a "normally reoccurring transaction" since the $7 million loan by Union Bank to ZBest vastly exceeded any other normal credit transaction which ZBest had entered into. This large loan was utilized to enhance and in furtherance of the ZBest fraudulent business enterprise.

While Petitioner may argue that its loan should be aligned with a sale of commercial paper, it is worth noting that the seller of short-term commercial paper (a financial institution or public corporation) is making a sale of inventory or short-term notes to assist it in the ordinary course of its business. It is obvious that it was the debtor/seller of commercial paper that sought protection since if it was unable to sell its inventory/notes, its slide into bankruptcy would be accomplished at a much quicker pace. Furthermore, extending protection to purchasers of short-term commercial paper provides assurances to such purchasers that continued business dealings with a financially troubled debtor will not result in adverse financial consequences upon the receipt of repayment. Through the redemption of commercial paper a debtor is once again able to reenter the money market and obtain additional short-term capital infusions for its continued business operation.[105]

[105] The Tenth Circuit decision in *Fidelity Savings & Investment Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989) clearly demonstrates these considerations by the Senate in discussing commercial paper redemptions. Additionally, see *CHG International*, *supra*, in which, at fn. 11, the Ninth Circuit determined the *Fidelity* opinion to be weak, and noted that the *Fidelity* court expressly refused to decide whether it agreed with cases that hold that long-term loans are excepted from treatment as a preference. *See also supra* note 10.

More importantly, the Tenth Circuit Court of Appeals in *Johnson v. Barnhill (In re Antweil)* 931 F.2d 689 (10th Cir. 1991) recently discussed the scope, purpose and intent of the trustee's preference avoiding powers. While the specific facts of the *Johnson* decision concerned the determination of the date upon which a "transfer" occurs for purposes of § 547(b), the Tenth Circuit provided insight as to the limited scope and applicability of § 547(c)(2). The Tenth Circuit noted that:

> "The most important purpose of § 547(b) is to facilitate equal distribution of the debtor's assets among the creditors . . . To accomplish this purpose, Congress has created an arbitrary time period consisting of the 90 days immediately preceding the filing of the bankruptcy petition . . . Creditors who receive payments on pre-existing debts before this time period begins may keep those payments. However, *creditors who receive payments on pre-existing debts within the 90-day period must disgorge those payments so that they may be shared equally with other creditors . . .*" At page 692. [Emphasis Added]

In discussing § 547(c), the Tenth Circuit explained:

> "The purpose of § 547(c) defenses is to encourage trade creditors and other suppliers of goods and services to continue dealing with troubled businesses without fear of the Trustee's avoiding powers." At page 693.[106]

Finally, the Tenth Circuit in discussing § 547(c)(2) stated:

[106] The *Johnson* decision contains limiting language as to the scope of protection provided by § 547(c)(2) which demonstrates consideration of matters not discussed in the *Fidelity* decision, *supra* note 105.

". . . Under this section, a power company, for example, may continue to supply a financially troubled company on condition that the company continue to make regular and timely payments." At page 693.

What becomes readily apparent is that the Tenth Circuit has recognized what the Seventh, Ninth and Eleventh Circuits had already concluded: that § 547(c)(2) is not intended to protect payments made on long-term, pre-existing debt during the 90-day period preceding the bankruptcy filing, but, rather, was intended to protect payments made to persons supplying value to the debtor during said 90-day period.

These facts are diametrically opposed to the facts of the case at bar. Specifically, Union Bank made one (1), segregated loan to ZBest which had a maturation date of over eight and one-half months. The policy discussed by the Senate in modifying the provisions of § 547(c)(2) to accommodate commercial paper sought to normalize the trade credit transactions in selling short-term commercial paper and to eliminate an artificial time limit is not applicable to the base at bar. If Congress had intended to totally emasculate the preference provisions as to payments made on long-term debt obligations, then Congress should have specifically stated that the exception provided by § 547(c)(2) is not limited to normal trade credit transactions but rather, encompasses all transactions between a debtor and *any* creditor. Congress did not so intend and this Court should not so construe a statute which was not specifically modified with the intent of including protection for payments on long-term debt obligations.

VI. THE NINTH CIRCUIT, RELYING ON *CHG INTERNATIONAL, INC.*, PROPERLY DETERMINED THAT PREFERENTIAL PAYMENTS UPON A LONG-TERM DEBT INSTRUMENT ARE OUTSIDE THE SCOPE OF THE PROTECTION AFFORDED BY § 547(c)(2).

In its *CHG International* decision, the Ninth Circuit *correctly* pointed out at page 1483 that § 547(c)(2) "was intended to complement the contemporaneous exchange section." In so finding, the Ninth Circuit relied upon the Seventh Circuit decision in *Barash, supra.*[107] Moreover, the Ninth Circuit correctly pointed out that:

> "The rationale for both the old 'current expense' rule and for § 547(c)(2) exception is the same: the payment does not diminish the estate, is not for an antecedent debt, and allows the debtor to remain in business." At 1483.

In the case at bar, the preferential transfers from ZBest to Petitioner, Union Bank:

(1) Diminished the estate;

(2) Were on account of an antecedent debt; and

(3) Did nothing to allow ZBest to remain in business.

Respondent urges this Court to recognize, as did the Ninth Circuit in *CHG International* and ZBest, the Seventh Circuit in *Barash*, the Tenth Circuit in *Johnson* and the Eleventh Circuit in *Marathon*, that the better view is that Congress did *not* intend to fundamentally change the preference avoiding powers but rather, to only eliminate an artificial time limit so as to normalize trade credit transactions on short-term financial arrangements.

---

[107] See also *Appeal of California Sunnyvale Associates (In re Xonics Imaging Inc.)*, 837 F.2d 763, 766 (7th Cir. 1988).

VII. THE ORDINARY COURSE OF BUSINESS EXCEPTION IS INAPPLICABLE TO A CREDITOR WHERE THE DEBTOR ENGAGED IN A FRAUDULENT BUSINESS SINCE THERE IS NO ORDINARY COURSE OF BUSINESS BEING CARRIED ON.

As argued in the lower court, but not decided by the Ninth Circuit Court of Appeals in the *ZBest* decision, a line of cases has developed which holds that a debtor who engages in a Ponzi/fraudulent business enterprise cannot be deemed to be operating an ordinary business and, therefore, creditors are unable to rely upon the ordinary course of business exception provided by § 547(c)(2) to avoid a preference attack by a trustee. See *Danning v. Bozek (In re Bullion Reserve of North America)*, 836 F.2d 1214 (9th Cir. 1988); *Graulty v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.)* 819 F.2d 214 (9th Cir. 1987).

While the Ninth Circuit did not reach this issue (as a result of its determination that the obligation owed by ZBest to Union Bank was a long-term debt obligation), if this Court should determine that the arguments of Petitioner have merit, then this Court should consider addressing the subsidiary issue which the Ninth Circuit failed to address. As aptly stated by the Ninth Circuit in *Bullion Reserve* and *Graulty*, respectively, the protection afforded under § 547(c)(2) was not intended to protect one victim of the debtor's fraud at the expense of others. Where a debtor engages in activities which are tantamount to a Ponzi scheme/fraudulent business enterprise, the debtors may not be said to be operating a legitimate trade or business and, therefore, no transaction can be considered "ordinary."

CONCLUSION

WHEREFORE, Respondent, Herbert Wolas, prays that the judgment of the United States Court of Appeals for the Ninth Circuit be affirmed.

Respectfully submitted,

TERRY A. ICKOWICZ
Counsel of Record
WOLAS, SOREF & ICKOWICZ
A Professional Corporation
1801 Century Park East
Suite 1717
Los Angeles, California 90067
(213) 277-0408

HERBERT WOLAS
Chapter 7 Trustee
ZZZZ BEST CO., INC.
1801 Century Park East
Suite 1717
Los Angeles, California 90067
(213) 277-0408
Attorneys for Respondent,
ZZZZ Best Co., Inc.

No. 90-1491

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

UNION BANK,
Petitioner,
v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

REPLY BRIEF OF PETITIONER

JOHN A. GRAHAM
Counsel of Record
LESLEY ANNE HAWES
FRANDZEL & SHARE
A Law Corporation
6500 Wilshire Boulevard
Seventeenth Floor
Los Angeles, California 90048-4920
(213) 852-1000

DONALD ROBERT MEYER
General Counsel
STEPHEN HOWARD WEISS
Deputy General Counsel
UNION BANK
445 South Figueroa Street
Los Angeles, California 90071-1602
(213) 236-5906
Attorneys for Petitioner, Union Bank

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

TABLE OF AUTHORITIES

CASES Page

STATUTES

LEGISLATIVE MATERIALS

In The
Supreme Court of the United States
October Term, 1991

No. 90-1491

Union Bank,
Petitioner,
v.
Herbert Wolas, Chapter 7 Trustee for the Estate of ZZZZ Best Co., Inc.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

REPLY BRIEF OF PETITIONER

This case concerns an ordinary commercial loan transaction and payments by the now-bankrupt borrower of regular minimum monthly interest charges and a small loan availability fee made to the Bank strictly in accordance with its loan documents and in a regular manner consistent with ordinary credit practices.[1] Pet. App. D at 12a, 14a. In support of the decision of the court below treating these payments as recoverable preferences, Respondent urges this Court to rewrite the language of § 547(c)(2)(A) so that the term "debt" as it appears

---

[1] In opposition to the Bank's summary judgment motion and in support of its cross-motion for summary judgment, the Trustee submitted no evidence contesting the ordinariness of the loan payments or of the loan terms.

there includes only "short-term trade debt" and not longer-term debt, which is at issue here.

Respondent's primary argument is that the legislative history of the statute shows that Congress "forgot" to promote the primary goal of the 1978 preference statute —equality of distribution—when it eliminated the 45-day rule and set forth no other limitation in the statute to prevent payments on all types of debts from being eligible for protection against preference avoidance. Although Respondent concedes that the legislative history of the 1978 Bankruptcy Code reveals other policies of the preference laws in addition to equality of distribution—i.e., maintaining normal business relations and preventing a race to the courthouse—Respondent argues that the Court should presume Congress would have preferred to promote equality of distribution over the other policies and should further presume that Congress would have found the equality of distribution goal to be better served by limiting the protection of § 547(c)(2) to short-term trade debt.

Even if Congress had inadvertently deleted the 45-day provision, "forgetting" to make any other limitation on the term "debt" in § 547(c)(2), it would not be the Court's role to conceive and write limiting language into the statute. A court's perception that a particular result is unreasonable is only relevant to an interpretation of an *ambiguous* statute and "cannot justify disregard of what Congress has plainly and intentionally provided." *Commissioner v. Asphalt Prods. Co., Inc.*, 482 U.S. 117, 121, 96 L.Ed.2d 97, 107 S. Ct. 2275 (1987). "It frustrates rather than effectuates legislative intent simplistically to assume that *whatever* furthers the statute's primary objective must be the law." (Emphasis in original.) *Rodriguez v. U.S.*, 480 U.S. 522, 526, 94 L.Ed.2d 533, 107 S. Ct. 1391 (1987). *See West Virginia Univ. Hospitals, Inc. v. Casey*, 499 U.S. ——, 113 L.Ed.2d 68, 84, 111 S. Ct. 1138 (1991) ("it is not our function to eliminate clearly expressed inconsistency of policy, and to

treat alike subjects that different Congresses have chosen to treat differently"). *See also United States v. Shreveport Grain & Elevator Co.*, 278 U.S. 77, 83, 77 L.Ed. 178, 53 S. Ct. 42 (1932) (committee reports "cannot be resorted to for the purpose of construing a statute contrary to the natural import of its terms"). Respondent cannot rely on generalized fragments of legislative history to provide a basis for ignoring the plain meaning of a statute. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 380, 98 L.Ed.2d 740, 108 S. Ct. 626 (1988).

In any event, there is no basis for believing that Congress's deletion of the 45-day limitation—without further qualification of the word "debt"—was at all inadvertent. The legislative history of the 1984 statute plainly expresses congressional concern that the 1978 version of § 547(c)(2) had interfered with normal financial relations so that "payments received in good faith by creditors were the subject of recovery actions." S. REP. No. 446, 97th Cong., 2d Sess. 24 (1982).[2] Congress intended that "regular payments, made voluntarily by the debtor in the ordinary course of business" would not be recoverable as preferences. *Id.* at 43. This legislative history is consistent with the plain language of the statute. *See* Brief of Petitioner at 12-17. The elimination of the 45-day rule is also no more in conflict with the goal of promoting equality of distribution than any other excep-

---

[2] Respondent's analysis improperly imputes to a later Congress the same legislative intent as that of Congress in 1978 in assuming that Congress intended to promote the equality of distribution principle above the concern of maintaining normal financial relations with all types of creditors when it eliminated the 45-day rule in 1984. *See* Brief of Respondent at 7 (in which Respondent cites legislative history from the 1978 Code to support the proposition that Congress intended to limit the ordinary course of business exception as amended in 1984 to trade debt).

tion of § 547(c) that allows a preference to remain unrecoverable.[3]

It is noteworthy that the language of the statute the Court is being asked to interpret in this case appears nowhere in Respondent's brief. The language in question protects transfers "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs." 11 U.S.C. § 547(c)(2)(A). The term "debt" means "liability on a claim." 11 U.S.C. § 101(12). To import the qualification of "short-term" and "trade" to the word "debt" is to fundamentally rewrite the statute based on the improper speculation that Congress did not really mean what it plainly said.

In the course of arguing for a judicial narrowing of the terms of § 547(c)(2), Respondent notes that the 1984 amendment of the statute was prompted by problems encountered in the application of the 45-day rule to certain trade debt, commercial paper and consumer debt. *See* Brief of Respondent at 9-11. Respondent concedes that loans evidenced by commercial paper have maturities of up to 270 days and that in floor statements before the passage of the bill Senators Dole and DeConcini made it clear that payments on commercial paper are to be protected under the ordinary course of business exception as amended in 1984. *See id.* at 12 n.17, 31-32; 130 CONG. REC. S8897, *reprinted in* App. 3 COLLIER ON BANKRUPTCY ch. XX, p. 80 (15th ed. 1990).

The revolving line of credit issued by the Bank in this case had a term of eight and one-half months, and the term of the "long-term" loan in *Matter of CHG Int'l, Inc.*, 897 F.2d 1479 (9th Cir. 1990), relied on by the Ninth Circuit in the *ZZZZ Best* decision, was *seven*

[3] In fact, there are six other exceptions to the trustee's right to recover transfers deemed to be preferential. The existence of these numerous other exceptions in § 547(c) confirms Congress's willingness to put aside the equality of distribution goal in favor of other, more compelling considerations when Congress deems it appropriate.

months. The commercial loans in these two Ninth Circuit decisions thus had shorter terms than commercial paper, which was unequivocally intended to be protected by the elimination of the 45-day rule. To adopt Respondent's position that the statute only protects payments on short-term trade debt yet accommodate the clear mandate of Congress that payments on long-term commercial paper be protected, Respondent would have the Court rewrite the simple term "debt" to create not only a limitation on the protection to short-term debt but also a special exemption to the limitation to protect payments on commercial paper with a term of up to 270 days. Such a reading of the statute would be absurd.

Finally, Respondent urges that judicial rewriting of the statute is necessary to avoid departure from "a long line of statutory and judicial history," which allegedly protected payments only on short-term trade debt. Brief of Respondent at 7. In fact, for 80 years the provisions of § 60 of the former Bankruptcy Act never distinguished between trade debt and long-term obligations. *See* Brief of Petitioner at 12-13; Brief of Amicus Curiae California Bankers Association at 20-21. Respondent, a footnote 35, specifically concedes as much. *See* Brief of Respondent at 16 n.35. The "long history" of only protecting payments on trade debt applies to a period of five years from 1979 to 1984, when the preference statute was revised to limit the statute's protection to debt that was paid within 45 days of the date it was incurred.

Respondent has cited several cases to support his claim that protection against preference attack was historically limited to trade debt. None of those cases supports that claim since all of the cases involve the interpretation of the 1978 Bankruptcy Code. Any references to limiting the application of § 547(c)(2)(A) exclusively to trade debt or short-term debt consist of passing references in *dicta* only.

The issue in *Barash v. Public Fin. Corp.*, 658 F.2d 504 (7th Cir. 1981) (*see* Brief of Respondent at 14, 34, 41) was whether regular payments on installment loans were voidable as preferences. The court concluded that some of them were, solely on the ground that the payments did not come within the 45-day rule. Since that rule has now been repealed, the rationale of *Barash* has no bearing on this case. Further, more recently the Seventh Circuit has noted in *dicta* in *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr., Inc.)*, 874 F.2d 1186, 1200 (7th Cir. 1986), that required monthly payments made over a year on a long-term note, if made on time, are protected under the current version of § 547(c)(2).

The Eleventh Circuit in *In re Craig Oil Co.*, 785 F.2d 1563 (11th Cir. 1986), also relied on by Respondent (*see* Brief of Respondent at 33-34), based its decision on the fact that payments were not in fact made in the ordinary course of business.[4] Its discussion of the (c)(2) exception as "directed primarily to ordinary trade credit transactions," 785 F.2d at 1567, in a case arising when the 45-day rule was in effect, is not helpful in understanding the state of the law either before October 1979 or after the 45-day limitation was stricken in 1984.

Respondent's judicial and statutory authorities in fact reveal that the 45-day rule and its resulting limitation to short-term trade debt was a new development in the 1978 Code which was roundly criticized after less than two

[4] The First Circuit in *WJM, Inc. v. Massachusetts Dep't of Pub. Welfare*, 840 F.2d 996, 1010 (1st Cir. 1988), cited by Respondent in a footnote (Brief of Respondent at 36 n.102) as offering some distant support for its view, also went off on this ground. The bankruptcy court decision in *In re Magic Circle Energy Corp.*, 64 Bankr. 269 (Bankr. W.D. Okla. 1986), *see* Brief of Respondent at 36 n.102, included very limited and cryptic comments which the court itself said were not "pertinent to the matter at bar." The court in that case found that a workout agreement did not transmute ordinary trade debt into a debt that was not incurred in the ordinary course of business or financial affairs.

years in operation and was quickly abandoned when the 1984 amendment deleted the 45-day rule. These authorities provide no basis for the Court to deviate from the plain meaning of the statute when Congress's intent is unequivocally expressed through a series of special exceptions, all of which protect admittedly preferential payments and therefore do not promote the equality of distribution goal.

CONCLUSION

Petitioner Union Bank respectfully submits that the Ninth Circuit erred in overturning the decisions of the bankruptcy and district courts in this matter and that the decision of the Ninth Circuit should be reversed.[5]

[5] Section VII of the Respondent's Brief urges a separate and distinct limitation in contradiction to the plain meaning of the statute based upon a line of cases applicable to *investors* in "Ponzi schemes." In the Ponzi scheme line of cases, investors who have fueled the scheme by investing money on the promise of receiving windfall profits are not protected because their "investments" are clearly not ordinary course transactions. This line of cases does not apply to a commercial bank lender involved in a routine loan transaction who is not an investor and had no expectation of any extraordinary profits. Appendix D to Petition for Writ of Certiorari at 14a-15a, Conclusions of Law, paras. 9 and 10. Because this issue was not decided by the Ninth Circuit, the Court has a choice of either reversing and remanding the case to the Ninth Circuit or simply reversing. Since, as a matter of law, the Ponzi line of cases does not apply to a bank in a routine commercial loan, Respondent's argument is plainly without merit and Petitioner urges the Court to reverse.

Respectfully submitted,

JOHN A. GRAHAM
Counsel of Record
LESLEY ANNE HAWES
FRANDZEL & SHARE
A Law Corporation
6500 Wilshire Boulevard
Seventeenth Floor
Los Angeles, California 90048-4920
(213) 852-1000

DONALD ROBERT MEYER
General Counsel
STEPHEN HOWARD WEISS
Deputy General Counsel
UNION BANK
445 South Figueroa Street
Los Angeles, California 90071-1602
(213) 236-5906

Attorneys for Petitioner,
Union Bank

(6)

No. 90-1491

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ BEST CO., INC.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION, *AMICUS CURIAE* SUPPORTING REVERSAL

JOHN L. WARDEN
H. RODGIN COHEN
ROBINSON B. LACY
MICHAEL M. WISEMAN

SULLIVAN & CROMWELL
Of Counsel

RICHARD H. KLAPPER
Counsel of Record for
The New York Clearing
House Association
Amicus Curiae
125 Broad Street,
New York, New York 10004.
(212) 558-3555

July 9, 1991

26 pp.

TABLE OF CONTENTS

Table of Authorities

Cases

IN THE

Supreme Court of the United States

October Term, 1990

No. 90-1491

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION, *AMICUS CURIAE* SUPPORTING REVERSAL

This brief is in support of reversal and is filed pursuant to Rule 37.3 with the consent of all parties.

Interest of *Amicus Curiae*

The New York Clearing House Association (the "Clearing House") is an association of 12 leading commercial banks in the City of New York.[1] The Clearing

[1] The members of the Clearing House are The Bank of New York, The Chase Manhattan Bank, N.A., Citibank, N.A., Chemical Bank, Morgan Guaranty Trust Company of New York, Manufacturers (continued...)

House regularly appears as *amicus curiae* in cases raising significant questions of law relating to banking. The Clearing House banks are among this country's largest consumer and commercial lenders, with more than $346 billion in domestic loans outstanding. The Clearing House banks have a substantial interest in the consistent application of a rational set of criteria to determine whether regularly scheduled payments of interest or principal on those loans are preferences under the Bankruptcy Code.

In the decision below, the Court of Appeals held that payments of interest and loan commitment fees on an eight-month revolving credit loan were preferential transfers under 11 U.S.C. § 547(b) and that the payments were not subject to the exemption from avoidance applicable to payments of indebtedness incurred and repaid in the ordinary course of the debtor's and lender's business or financial affairs under 11 U.S.C. § 547(c)(2). In determining that the payments were not subject to the ordinary course exemption, the court applied a *per se* rule that interest payments on long-term debt are not made in the ordinary course of business and held without discussion that for purposes of this rule an eight-month revolving credit loan is a long-term debt.

In deciding this case, the Ninth Circuit followed its prior decision in *CHG International, Inc.* v. *Barclays Bank (In re CHG International, Inc.)*, 897 F.2d 1479 (9th Cir. 1990). There, the Court of Appeals held that "long-term" debt—which it did not define—could not be incurred in the

[1](...continued)
Hanover Trust Company, Bankers Trust Company, Marine Midland Bank, N.A., United States Trust Company of New York, National Westminster Bank USA, European American Bank and Republic National Bank of New York.

ordinary course of a debtor's business or financial affairs. 897 F.2d at 1486. The court did not refer to any statutory or other support for this rule, but simply asserted without authority that section 547(c)(2) applies only to payments to trade creditors and other short-term creditors. In the present case, the Court of Appeals refused even to consider whether Petitioner's eight-month revolving credit line had been incurred in the ordinary course of the debtor's business or financial affairs. *Wolas* v. *Union Bank (In re ZZZZ Best)*, 921 F.2d 968, 969 (9th Cir. 1990). The use of such arbitrary, *per se* rules in applying the ordinary course exemption will result in unfairness to commercial lenders and artificial and uneconomical restrictions on the availability of credit to borrowers.

Summary of Argument

The section 547(c)(2) "ordinary course" exemption from avoidance of otherwise preferential transfers does not on its face distinguish among types of credit or contain any *per se* rules for determining whether a debt was incurred and paid in the "ordinary course of business or financial affairs." Congress eliminated the statute's only *per se* rule in 1984 when it deleted the requirement that repayment occur within 45 days after the debt was incurred. The Ninth Circuit's attempt to create new *per se* categories of debt ineligible for the exemption is inconsistent with the plain language, legislative history and purpose of the statute.

The preference provisions of the Bankruptcy Code are intended to ensure an equitable distribution of the debtor's estate by authorizing avoidance of certain transfers made on the eve of bankruptcy that have the effect of favoring one creditor over another. This assurance of equitable distribution encourages creditors to continue dealing with a troubled debtor and discourages a rush to demand repay-

ment. The special exemption for payments made in the "ordinary course" is a key element of the preference provisions of the Code because it assures creditors meeting the ordinary credit needs of the borrower that payments made to them in the manner originally agreed will not be subject to avoidance.

Creation of a *per se* rule excluding all payments on long-term debt from the "ordinary course" exemption creates arbitrary distinctions and incentives for banks and other creditors to act in ways contrary to the policies underlying the preference provisions. If potential long-term lenders know that they will automatically be denied the benefit of the "ordinary course" exemption, they will be discouraged from providing the long-term credit debtors need for financial stability and, in many cases, more flexible and less expensive financing. The consequence will be to increase the frequency of liquidity crises for individual and corporate borrowers and to decrease the flexibility and increase the cost of credit. Moreover, existing long-term lenders will have less incentive to work with the debtor in restructuring debt or to continue to provide credit. Long-term creditors instead will be encouraged to withdraw credit and recover principal as soon as the debtor encounters financial difficulty in order to avoid having repayments fall within the preference period.

Section 547(c)(2) does not require that payments on long-term debt be treated in a manner that results in behavior so manifestly at odds with the goals of the Bankruptcy Code. The Ninth Circuit's *per se* rule, and indeed any *per se* rule for applying the ordinary course exemption, should be rejected.

ARGUMENT

I.

The Language of Section 547(c)(2) Creates No Distinctions Among Types of Credit Arrangements in Determining Whether a Debt Was Incurred and Payment Was Made in the Ordinary Course.

Section 547(c)(2) by its terms draws no distinctions between the types of debt that qualify for or are excluded from the ordinary course exemption, nor does the language suggest that the courts should create arbitrary categories of exclusion or inclusion. Rather, section 547(c)(2) requires a determination of whether, in the circumstances presented, the debt was created and the payment made "in the ordinary course of business or financial affairs" of the debtor and lender.[2] This is plainly a fact-based standard not susceptible to *per se* rules.

The approach adopted by the Ninth Circuit in this case would require that the courts arbitrarily categorize the numerous and evolving types of credit based solely on the term of the debt, without reference to the "ordinary course"

---

[2] Section 547(c)(2) provides:

"The trustee may not avoid under this section a transfer—

". . . .

"(2) to the extent that such transfer was—

"(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

"(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

"(C) made according to ordinary business terms."

determination mandated by section 547(c)(2). The courts would be required to decide whether the line between "long-term" and "short-term" occurs at 30 days, 90 days, 180 days, 240 days or some other point, and to do so without any statutory guidance or any reference to the business or financial affairs of the specific debtor. This refusal to take into account the precise facts that Congress prescribed as the criteria for applying section 547(c)(2) would only frustrate the policy of exempting ordinary course payments from attack as preferences.

The approach taken by the Ninth Circuit fails to recognize that long-term debt is a common component of the capital structure of most corporate debtors, *see* V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 133-34 (3d ed. 1987). Long-term debt finances the purchase of facilities and equipment and provides general corporate funds and working capital. Debtors may incur long-term debt frequently (*e.g.*, to finance office equipment) or infrequently (*e.g.*, by issuing publicly traded debentures). All of these borrowings serve the debtor's ordinary credit requirements. Absent extraordinary circumstances, regularly scheduled payments of interest or principal on these debts do not prefer one creditor over another.[3] A *per se* rule cannot distinguish between ordinary and extraordinary debts and payments based solely on the term of the loan.

---

[3] When payments of interest and principal are made according to a schedule agreed on well before the debtor encounters financial difficulty, there is less likelihood that the debtor prefers the creditor when it makes regular payments. Moreover, because the obligation to pay interest arises only when the debtor uses the money, courts have held that regularly scheduled interest obligations are incurred and paid in the ordinary course of the debtor's financial affairs. *See Iowa Premium Serv. Co.* v. *First Nat'l Bank (In re Iowa Premium Serv. Co.)*, 695 F.2d 1109, 1111-12 (8th Cir. 1982).

In contrast, the approach taken by the Court of Appeals for the Sixth Circuit in *Gosch* v. *Burns (In re Finn)*, 909 F.2d 903, 907-08 (6th Cir. 1990), is consistent with the language of section 547(c)(2). There the Court of Appeals stated that, on its face, section 547(c)(2) applies to "all debt incurred 'in the ordinary course'" and was "barren" of any *per se* limits on the type of debt that qualifies for the exemption. *Id.* at 908. The Sixth Circuit rejected the argument that payments on long-term debt cannot be exempted from avoidance and directed that the lower court conduct the factual analysis necessary to determine whether the consumer loan at issue had been incurred in the ordinary course of the debtor's financial affairs. *Id.* The Ninth Circuit's use of a *per se* rule also conflicts with the approach taken by the Tenth Circuit. *See Fidelity Sav. & Inv. Co.* v. *New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989); *cf. Levit* v. *Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1200 (7th Cir. 1989) (arguing that ordinary, timely payments on long-term debt are exempt under section 547(c)(2) from attack as preferences).

This Court has made clear that the Bankruptcy Code should be applied as written. *See Toibb* v. *Radloff*, 59 U.S.L.W. 4633, 4634 (June 13, 1991); *United States* v. *Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989). Because the plain language of the statute unambiguously makes the exemption depend on whether the payment was in the ordinary course of the borrower's and lender's business and financial affairs, the courts are not at liberty to adopt different, *per se* criteria unrelated to the parties' specific circumstances. *See Sullivan* v. *Stroop*, 110 S. Ct. 2499, 2504 (1990).

II.

When Congress Eliminated the 45-Day Limit in 1984, It Intended That All Ordinary Course Debt Qualify for the Section 547(c)(2) Exemption.

The sparse legislative history of section 547(c)(2) reflects Congress' intention to leave the determination of whether payments are in the "ordinary course" to a case-by-case analysis, rather than to create artificial categories or a *per se* rule. As originally enacted, section 547(c)(2) applied only to "ordinary course" transfers made within 45 days after the debt was incurred. Bankruptcy Reform Act of 1978, Pub. L. 95-598, § 547(c)(2), 92 Stat. 2549, 2598. Cases interpreting section 547(c)(2) generally turned on whether payments were made within the 45-day period, and not on the nature of the debt. *See, e.g., Sanborn* v. *Bangor Fed. Credit Union (In re Sanborn)*, 29 Bankr. 655 (Bankr. D. Me. 1983); *Kampf* v. *Postal Finance (In re Keeling)*, 11 Bankr. 361 (Bankr. D. Minn. 1981).

The bright line created by the 45-day rule caused creditors to tailor their credit terms—often in commercially inefficient ways—to fall within the exemption. *See Preference Section of the Bankruptcy Code: Hearings on S. 3023 Before the Subcomm. on Judicial Machinery of the Senate Judiciary Comm.*, 96th Cong., 2d Sess. 8-17 (1980). For example, commercial paper was frequently issued with maturities shorter than 45 days to meet concerns about preference risks, even though both borrowers and lenders preferred maturities as long as 270 days. *Id.* at 9. Use of short-term credit to meet longer-term financing needs increased transaction costs, including the cost of redocumenting the credit arrangement every time it was renewed. To avoid these inefficiencies, certain creditor groups

proposed to amend section 547(c)(2) to extend or eliminate the 45-day time limit, or to create new exemptions from avoidance for certain types of credit. *See* DeSimone, *Section 547(c)(2) of the Bankruptcy Code: The Ordinary Course of Business Exception Without the 45 Day Rule*, 20 AKRON L. REV. 95, 130-31 (1986).

When Congress eliminated the 45-day rule in 1984, however, it did not replace it with either a different time limit or an enumeration of specific types of credit qualifying for the ordinary course exemption. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462, 98 Stat. 333, 378. To protect only short-term credit, Congress could easily have limited the exemption to payments made within nine months or one year of the date the debt was incurred. Instead, Congress declined to specify any time restriction, thereby removing from section 547(c)(2) the only *per se* restriction on the type of ordinary course debt qualifying for the exemption that it had ever contained. *See* Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 776 (1985). Moreover, although Congress was particularly influenced by the effect of the 45-day rule on the commercial paper market,[4] the amendment did not refer to

---

[4] The Senate sponsor of the 1984 amendment emphasized that the exemption would apply to commercial paper with a term of more than 45 days because "participants [in the commercial paper market] would presumably be acting in the ordinary course of their business or financial affairs and on the basis of ordinary business terms." Floor Statement on H.R. 5175 (Pub. L. 98-353), 130 CONG. REC. 8887, 8897 (daily ed. June 29, 1984). Although the Clearing House opposes any *per se* rule, the clear inconsistency between the Ninth Circuit's ruling and the intent of Congress is illustrated by the fact that the eight-month maturity rule the Ninth Circuit adopted would (continued...)

commercial paper or otherwise limit the types of credit to which the exemption applied.

The legislative history demonstrates that neither trade creditors, nor commercial paper holders, nor short-term lenders generally, are the exclusive beneficiaries of the ordinary course exemption. The legislative history clearly indicates that Congress intended to make the "ordinary course" inquiry a fact-based one. Any lender that meets the ordinary course requirements of section 547(c)(2) based on the circumstances of the specific borrower, lender, indebtedness and payment is entitled to the exemption from avoidance as a preference.

III.

The Wide Variety of Credit Arrangements Requires a Fact-Based Determination of Whether a Debt Was Incurred and Payment Was Made in the Ordinary Course.

The Clearing House member banks provide credit to consumers and businesses utilizing a myriad of terms, structures and forms.[5] Credit in numerous forms is also available from other financial institutions and the public and private capital markets. Payments of principal, interest and fees on all these types of credit are subject to attack as

[4](...continued)
exclude a significant number of commercial paper issues, which can have a maturity of up to nine months. *See* Securities Act of 1933 § 3(a)(3), 15 U.S.C. § 77c(a)(3) (exemption for commercial paper).

[5] For an introduction to basic loan terms and structures, *see* G. RUTH, COMMERCIAL LENDING 237-288 (2d ed. 1990); M. STIGUM, THE MONEY MARKET 35-64 (3d ed. 1990); G. MUNN & F. GARCIA, ENCYCLOPEDIA OF BANKING AND FINANCE 572-73 (8th ed. 1983).

preferences unless they qualify under the ordinary course or some other exemption. No *per se* rule can categorize all these types of credit as ordinary or extraordinary on any but the most arbitrary basis.

A *per se* rule cannot hope to keep abreast of the rapidly evolving new forms of credit, *see New Financial Products and Techniques 1990*, 678 PRACTISING LAW INST. CORP. SERIES (G.K. Palm ed. 1990); *New Financial Products and Techniques 1989*, 630 PRACTISING LAW INST. CORP. SERIES (G.K. Palm ed. 1989). A *per se* rule will instead cause artificial and inefficient responses to credit requests because lenders will tailor their credit arrangements to fit within the *per se* rule and thereby obtain the benefit of the ordinary course exemption. Lenders will be more likely to extend credit to a financially troubled debtor only on a short-term or fully secured basis, which would severely limit the borrower's ability to obtain additional credit. *Per se* rules based on either the term of the loan or the frequency of borrowing—presumably the standards proposed by the Ninth Circuit—cannot hope to distinguish between ordinary and extraordinary credit arrangements.

The futility of classifying credit facilities according to their types or nominal maturity to determine whether a payment was in the ordinary course can be illustrated by examples of very common credit arrangements.

(1) A toy company has a $5,000,000 revolving credit facility with a three-year term and a provision that any balance outstanding at the end of three years becomes a two-year term loan due in installments. *See generally* S. STERN, STRUCTURING COMMERCIAL LOAN AGREEMENTS 1-4 to 1-9 (2d ed. 1990) (describing revolving credit facilities). During the initial three-year period the toy company may borrow and repay up to $5,000,000 as

frequently as it chooses. Alternatively, it may draw down the full amount and keep it outstanding for the entire three years. In fact, the toy company typically borrows a significant amount under the revolving credit facility only over the holiday season to provide working capital required to finance the gap between the manufacture of the toys and receipt of the proceeds from their sale. In this example, the time between the company's drawings on the credit facility and repayment may vary, with some amounts drawn in each of the months from August through November, and repayments made from January through March.

(2) Two electronics firms obtain revolving credit facilities identical to the toy company's facility. Both immediately draw down the full amount of the facility and keep that amount outstanding for the full five years (three years for the facility and two years for the term loan). One uses the facility to finance a program of acquisitions and the other uses it to finance part of the cost of a new plant.

(3) A builder borrows $5,000,000 under a two-year term loan to finance the construction of houses for resale. While the loan will be outstanding much longer than the seasonal borrowing by the toy maker, it performs the same working capital function for the builder, who uses the proceeds to pay subcontractors and other suppliers.

(4) The toy company obtains a letter of credit providing that the issuing bank will pay the company's suppliers upon submission of written documentation that they have delivered parts to the company. The bank can either reimburse itself from the customer's account or provide for reimbursement in the form of a term loan payable over a period ranging from several months to several years. The letter of credit may be outstanding for a prolonged period,

although reimbursement of any amount drawn on the letter of credit may be required immediately.[6]

(5) A large manufacturing company routinely issues $50,000,000 in commercial paper to provide working capital. Because its access to the commercial paper market could be curtailed due to either a decline in the company's credit standing or a disruption in the commercial paper market, the company obtains a $50,000,000 line of credit to provide a backup to its commercial paper facility. *See generally* 5 V. DiLorenzo, Banking Law 96-133 to 96-134 (1991) (explaining use of back-up line of credit); M. Stigum, The Money Market 1033-36 (3d ed. 1990) (same). If drawn, the loan pursuant to the line of credit may remain outstanding for a year or more. Yet the loan would provide the same working capital financing as the commercial paper facility, which Congress clearly intended to bring within the ordinary course exemption.

As these examples demonstrate, a borrower may utilize different types of credit arrangements to serve the same financing need, and most credit arrangements are designed to provide the borrower with the flexibility to use the funds for many purposes. Borrowers benefit from the resulting price competition between similar products and the availability of credit from different sources. Credit arrangements also usually provide a borrower flexibility as to when to borrow, how much to borrow, and when to repay the debt in whole or in part. *See, e.g.*, G. Ruth, Commercial Lending 237-38 (2d ed. 1990) (discussing the choice of loan structure).

---

[6] For a discussion of letter of credit arrangements, see J. Dolan, The Law of Letters of Credit (2d ed. 1991); B. McCullough, Letters of Credit (1991).

The specific credit arrangement before the Court demonstrates the arbitrariness inherent in applying a *per se* rule based on the term of the loan. Revolving credit facilities, such as that provided by Petitioner, allow a debtor to borrow and make repayments as credit is needed. The debtor may borrow and repay several times during the term of the facility, each time for a term as short as a single day. If the debtor makes several drawings on the line and repays the loan in several installments, a court would be required to engage in an arbitrary process of matching payments made within the preference period to one or more of the drawings in order to compute the "term" of the loan. Even if a court is able to conclude that a certain period, such as eight months, elapsed between a particular drawing and its repayment, this surely cannot preclude a factual determination that the indebtedness was incurred and repaid in the ordinary course of the debtor's and lender's business or financial affairs.

An additional obstacle to application of a *per se* rule is the fact that many credit arrangements have no single, unchangeable term. As the examples above demonstrate, some credit arrangements are designed to provide both short-term and long-term credit, or to convert short-term credit to long-term credit in certain circumstances. Similarly, a debt may be incurred as short-term credit and subsequently be refinanced to provide a longer maturity or more flexible repayment terms. Nothing about the fact of conversion or refinancing necessarily takes the debt outside of the ordinary course of a debtor's business or financial affairs. In fact, the debt may serve the same credit needs, only over a longer period of time.

In *Gosch* v. *Burns (In re Finn)*, *supra*, for example, the debtor refinanced $3500 in credit card debt as a consumer loan payable over a period of several years. The debtor then

made regular payments of interest and principal. The Sixth Circuit held that "incurring the loan did not increase the borrower's total indebtedness, nor was the loan disproportionate to the borrower's apparent earning power at the time." 909 F.2d at 908. The loan and the payments made under it were no more extraordinary than the credit card balance and payments they replaced.

The Ninth Circuit's approach is especially difficult to apply to the novel types of credit facilities appearing in credit markets. Commercial credit today has terms and structures that the drafters of the 1984 amendment to section 547(c)(2) could not have anticipated. *See New Financial Products and Techniques 1990*, 678 PRACTISING LAW INST. CORP. SERIES (G.K. Palm ed. 1990); *New Financial Products and Techniques 1989*, 630 PRACTISING LAW INST. CORP. SERIES (G.K. Palm ed. 1989). The constant evolution of the forms of credit further demonstrates the wisdom of Congress' decision to leave to the courts the case-by-case determination of whether both newly devised and traditional credit arrangements were established and repaid in the ordinary course. It is plainly arbitrary to attempt to categorize credit facilities for purposes of the ordinary course exemption by looking to either the facility's nominal maturity or the label placed on it. Only a review of the circumstances surrounding the debt, the challenged payment and the lender's and debtor's "business and financial affairs" will show whether or not the payment qualifies for the section 547(c)(2) exemption.

IV.

The Policies Underlying the Preference Provisions Argue Against Any Categorization of Types of Credit To Determine "Ordinary Course" Status.

Two policies central to bankruptcy law—equitable distribution of the debtor's assets and preservation of the debtor's estate—underlie the preference section. A rule that excludes whole categories of debt from the protection of section 547(c)(2) is inconsistent with both these policies.

A. Equitable Distribution of the Debtor's Assets.

Equitable distribution of the value of the debtor's assets among its creditors is a fundamental goal of both the Bankruptcy Code in general and the preference rules in particular. H.R. REP. NO. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138. The Bankruptcy Code seeks to ensure that the proceeds of the estate are distributed according to priorities set out in the Code and state commercial law. The preference provisions prevent individual creditors from obtaining full payment of their claims immediately before bankruptcy while similarly situated creditors receive a fraction of their claims in the bankruptcy case.

Excluding long-term debt payments from the protection of section 547(c)(2) is inconsistent with the goal of equitable distribution. Such a *per se* rule in effect prefers the judicially defined class of "short-term creditors" at the expense of "long-term creditors" on the basis of what may be nothing more than arbitrary labeling. Moreover, the distinction between short-term credit and long-term credit frequently does not exist for a financially troubled company. Short-term credit such as trade credit and commercial paper often

substitutes for long-term credit when it is regularly renewed. Similarly, long-term credit becomes in effect short-term credit when a debtor experiences financial difficulty and violates covenants in a loan agreement that authorize acceleration of the loan. In both cases, the creditor can choose to permit further use of its credit or to withdraw the credit, and thereby hasten the debtor's descent into bankruptcy.

If a long-term creditor proves that the loan was extended, and that repayments during the preference period were made, in the ordinary course of the debtor's and lender's business or financial affairs, then those payments should be exempted from avoidance under section 547(c)(2). To hold otherwise is to penalize the long-term creditor for the benefit of short-term creditors, creating an inequitable distribution of the sort the Bankruptcy Code seeks to prevent.

B. Preservation of the Debtor's Estate.

The exemptions from the general preference provisions serve the second fundamental policy of bankruptcy law: to preserve the debtor's estate by discouraging creditors from dismembering the business of a faltering debtor prior to bankruptcy. The exemptions are designed to create incentives for creditors to refrain from engaging in a "race of diligence" to obtain more value than will be available once a bankruptcy petition is filed, thus protecting debtors from being stampeded into unnecessary bankruptcy. H.R. REP. NO. 595, 95th Cong., 1st Sess. 177, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138; DeSimone, *Section 547(c)(2) of the Bankruptcy Code: The Ordinary Course of Business Exception Without the 45 Day Rule*, 20 AKRON L. REV. 95, 99 (1986).

To further the policy of preserving the debtor's estate, the same incentive to continue to provide credit must be offered to the long-term creditor as is offered to the short-term creditor. To deny long-term creditors the protection of section 547(c)(2) encourages long-term creditors to accelerate repayment on outstanding debts—the very action the preference law seeks to discourage—in order to avoid having payments fall within the preference period preceding the bankruptcy. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 177, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138. Alternatively, without the protection of section 547(c)(2), a long-term creditor may decide to force the debtor into bankruptcy before the debtor's assets are depleted by non-recoverable payments made to short-term creditors who are protected by the "ordinary course" exemption.

The aims of the preference provisions cannot be achieved through the creation and mechanical use of *per se* rules to create categories of debt that fall within or outside of the "ordinary course" exemption, without any analysis of the particular debtor's "business or financial affairs." Rather, section 547(c)(2) requires a case-by-case determination whether, in light of the policies underlying the preference rules and the particular debtor's business and financial affairs, the indebtedness at issue was incurred and repaid in the "ordinary course."

Conclusion

For the reasons stated herein, The New York Clearing House Association urges that this Court reverse the judgment of the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

RICHARD H. KLAPPER
Counsel of Record for
The New York Clearing
House Association
Amicus Curiae
125 Broad Street,
New York, New York 10004.
(212) 558-3555

JOHN L. WARDEN
H. RODGIN COHEN
ROBINSON B. LACY
MICHAEL M. WISEMAN

SULLIVAN & CROMWELL
Of Counsel

July 9, 1991

(7)

No. 90-1491

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

UNION BANK,
Petitioner,
vs.
HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ BEST CO., INC.,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF OF CALIFORNIA BANKERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

ROBERT L. MORRISON
Counsel of Record
KENNETH N. RUSSAK

PILLSBURY MADISON & SUTRO

725 South Figueroa Street, Suite 1200
Los Angeles, California 90017
(213) 488-7100

Attorneys for Amicus Curiae
CALIFORNIA BANKERS ASSOCIATION

Lawyers Brief Service / Legal Printers / (213) 383-4457 / (714) 720-1510

30

No. 90-1491

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

UNION BANK,
Petitioner,
vs.
HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF OF CALIFORNIA BANKERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

ROBERT L. MORRISON
Counsel of Record
KENNETH N. RUSSAK

PILLSBURY MADISON & SUTRO

725 South Figueroa Street, Suite 1200
Los Angeles, California 90017
(213) 488-7100

Attorneys for Amicus Curiae
CALIFORNIA BANKERS ASSOCIATION

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Laws and Statutes:

Legislative Materials:

Secondary Authorities:

No. 90-1491
IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1990

UNION BANK
Petitioner,
v.
HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ BEST CO., INC.,
Respondent.

BRIEF OF
CALIFORNIA BANKERS ASSOCIATION
AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONER

INTERESTS OF *AMICUS CURIAE*

The California Bankers Association ("CBA"), organized as a California nonprofit corporation, is a trade association with over 450 members. CBA's members include virtually every commercial bank in California.

The members of the CBA have a significant stake in the outcome of this case. The Ninth Circuit's elimination of the ordinary course of business exception to preference actions for long-term loans,

and perhaps all bank loans, will adversely affect CBA members. Unless the decision of the Ninth Circuit is reversed, CBA members will not be able to defend against bankruptcy preference actions by proving that they had dealt with their borrowers on ordinary business terms during the borrowers' unfortunately unsuccessful efforts to avoid bankruptcy. Instead, California banks, and other financial institutions in jurisdictions following the Ninth Circuit, will lose a strong incentive to continue to provide credit to borrowers who may have suffered a down-turn, but remain able to service their debts in the ordinary course of business.

SUMMARY OF ARGUMENT

The Ninth Circuit based its holding below on a fundamental misconception about the nature of the ordinary course of business exception. It viewed the exception as being essentially indistinguishable from the "contemporaneous exchange" exception separately provided for in the preference statute. This error formed the basis of the Ninth Circuit's ruling that the ordinary course of business exception is not available for long-term credits.

Ordinary course of business payments have been protected throughout the history of the preference laws of the United States not because of a solcitude for payments made in exchange for recent extensions of credit. Rather, they are protected in order to create incentives which will deter the "race of diligence" and lead to constructive debtor/creditor behavior so that fewer bankruptcies will occur. These goals are at least

as important and realizable in the case of long-term credits as short-term credits. The decision below should be reversed.

ARGUMENT

I
INTRODUCTION.

a. Overview.

Section 547(c)(2) of the Bankruptcy Code, 11 U.S.C. § 547(c)(2) (1979 & Supp. 1991), as first enacted in 1978, provided that the ordinary course of business exception in preference actions was available only to creditors who received the challenged payment within 45 days after creation of the debt on which the payment was made.[1] As originally drafted, the exception therefore could only cover payments made

---

[1] Section 547(c)(2), as enacted in 1978, read:

> (c) The trustee may not avoid under this section a transfer—
>
> * * *
>
> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made not later than 45 days after such debt was incurred;
>
> (C) made in the ordinary course of business or financial affairs of the debtor and transferee; and
>
> (D) made according to ordinary business terms;

Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 at 2598.

within an ordinary billing cycle typical for short-term credit transactions. *Barash v. Public Finance Corp.*, 658 F.2d 504, 511 (7th Cir. 1981).

The 45-day limitation was deleted in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333, 378 (1984).[2] The wholesale elimination of the 45-day limitation was not qualified in any fashion. Thus, under the plain language of the statute, an otherwise preferential payment could be exempted from preference recovery even if the invoice and payment came months, if not years, after credit was first extended, so long as the payment was (1) made on a debt incurred in the ordinary course of business of the debtor and creditor, (2) made in the ordinary course of business of the debtor and creditor, and (3) made according to ordinary business terms. I1 U.S.C. § 547(c)(2)(A)-(C). There is no longer any requirement that the payment be made within 45 days after the debt was incurred.

Since the 1984 Amendments, the Sixth Circuit, relying on the plain language of the statute, held that "[b]y eliminating the 45-day limitation, and neither stating nor implying any other limitation, Congress's language left the field open to long-term consumer debt for exception under § 547(c)(2)." *Gosch v. Burns (In re Finn)*, 909 F.2d 903, 908 (6th Cir. 1990). In

---

[2] That section of the Act provided:

"Section 547 of title 11 of the United States Code is amended in subsection (c)(2) thereof by striking out subparagraph (B) of such subsection, and by redesignating subparagraphs (C) and (D) thereof as subparagraphs (B) and (C), respectively." *Id.*

addition, the Tenth Circuit has held that the "broad language of § 547(c)(2) and the intent that this section apply to situations outside of the trade credit arena" makes the exception available, at a minimum, to commercial creditors holding savings certificates with maturities of up to one year (reserving determination as to whether the exception may be employed by creditors under longer term instruments). *Fidelity Sav. & Inv. Co. v. New Hope Baptist*, 880 F.2d 1172, 1176 (10th Cir. 1989). Moreover, the Seventh Circuit based its controversial *Deprizio* decision in part on an assessment that the "ordinary course of business" exception to a preference action is available to long-term commercial lenders. *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Co.)*, 874 F.2d 1186, 1200 (7th Cir. 1989). Only the Ninth Circuit has concluded that the plain meaning of the amended statute should be ignored, issuing two opinions, including the case below, which together exclude virtually all commercial loans from the protection of the "ordinary course of business" exception as a matter of law. *Wolas v. Union Bank (In re ZZZZ Best Co.)*, 921 F.2d 968, 969 (9th Cir. 1990); *CHG Int'l, Inc. v. Barclays Bank (In re CHG Int'l, Inc.)*, 897 F.2d 1479, 1483 (9th Cir. 1990).

b. The Ninth Circuit's Rationale.

The Ninth Circuit's interpretation of the ordinary course of business exception is founded upon a fundamental misconception about the nature of the exception and its relationship to the policies underlying the preference statute. In the *CHG* decision, the progenitor of the case below, the Ninth Circuit wrote that the "rationale for the old 'current expense rule' and for the section 547(c)(2) ordinary course of

business exception is the same." *In re CHG Int'l*, 897 F.2d at 1483. Thus, the Ninth Circuit apparently reasoned that an ordinary course of business payment can only be a payment which "does not diminish the estate, is not for an antecedent debt, and allows the debtor to remain in business." *Id.* On this analysis, the Ninth Circuit has concluded, as a matter of law, that payments on account of long-term debt could not fall within the exception because "nothing is exchanged at the time of the payments with the debtor which helps him to continue in business. There is merely an outflow of money from the estate." *Id.* at 1485.

The now extinct 45-day rule was seen by the Ninth Circuit as furthering the purposes of the exception because "'payments made within the 45-day credit cycle were so close to "contemporaneous" that they were not to be treated as payments on "antecedent" debts.'" *Id.* at 1483 (citation omitted). The deletion of the 45-day requirement was seen by the Ninth Circuit as nothing more than the elimination of a bright line test for such virtually "contemporaneous" transactions. The Ninth Circuit thereby justified its apparent conclusion that courts applying the exception must determine whether the challenged payment was so close in time to the incurring of the debt that the payment "[did] not diminish the estate, [was] not for an antecedent debt, and allow[ed] the debtor to remain in business."[3]

[3] The Seventh Circuit adopted a similar analysis of the ordinary course of business exception when the statute included the 45-day limitation. *Barash v. Public Fin.*, 658 F.2d at 504. After the 1984 amendments, however, the Seventh Circuit concluded that the ordinary course of business exception is available for payments on account of long-term debt. *See In re Deprizio*, 874 F.2d at 1200.

II
THE ORDINARY COURSE OF BUSINESS EXCEPTION WAS DESIGNED TO DISCOURAGE UNUSUAL ACTION BY THE DEBTOR AND ITS CREDITORS, NOT TO PROTECT PAYMENTS IN EXCHANGE FOR RECENT EXTENSIONS OF CREDIT.

a. Ordinary Course Payments Are Protected *Not* Because They Often Do Not Diminish The Estate, But Because The Exception Helps Avoid Bankruptcy In the First Instance.

The Ninth Circuit simply is incorrect in its assumption that "the rationale for the old 'current expense rule' and for the section 547(c)(2) ordinary course of business exception is the same." While the ordinary course of business exception may indeed "complement" the contemporaneous exchange exception, *In re CHG Int'l*, 897 F.2d at 1483, *nothing* in the legislative history or in decades of pre-Code law even suggests that the purpose of the ordinary course of business exception is to protect only those payments which do not diminish the estate. No doubt, many payments made in the ordinary course of business—including, significantly, interest payments made to maintain credit availability under long-term revolving lines of credit—have the additional salutary effect of keeping a debtor supplied with the capital, goods and services needed to avoid bankruptcy.[4] However, the legislative history of the 1978 Code and a long history of cases under the former Bankruptcy

[4] *See* discussion *infra* at pp. 12-13.

Act show that the corollary purposes of the exception are to prevent creditors from engaging in the so-called "race of diligence" and to give creditors an incentive to work with debtors on ordinary business terms so that bankruptcy might be avoided.

In this sense, the ordinary course exception "complements" the contemporaneous exchange exception, because a debtor is unlikely to have the funds to pay for its current expenses if it is being dismembered by assaults from its long-term creditors. Moreover, certain ordinary course payments on account of long-term revolving lines of credit can advance the policies behind both exceptions: the bank's continued willingness to maintain an ordinary credit relationship will give the borrower access to the capital it needs to fund its ongoing operations and to remain profitable and solvent. The important point, however, is that the ordinary course of business exception is fundamentally grounded on a different rationale than the other exceptions set forth in section 547(c).

The ordinary course of business exception was enacted to create an incentive structure that would help "leave undisturbed normal financial relations, because [the exception] does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." House Comm. on the Judiciary, Bankruptcy Reform Act of 1978, H.R. Rep. No. 595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6329 (hereinafter House Report). *See Coral Petroleum Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1355 (5th Cir. 1986), *reh. denied*, 801 F.2d 398 (5th Cir. 1986); 4 Collier on Bankruptcy ¶ 547.01 at

547-11 (15th ed. 1991). By penalizing aggressive creditor action and rewarding cooperative behavior, the exception helps reduce the number of bankruptcies because borrowers are granted access to the capital, goods and services needed to earn their way out of financial difficulty. House Report 177-78 ("The protection thus afforded the debtor [by the preference section] often enables him to work his way out of a difficult financial situation through cooperation with all his creditors."). *See also Coral Petroleum*, 797 F.2d at 1355 (quoting House Report); 4 Collier on Bankruptcy ¶ 547.01 at 547-11 (15th ed. 1991).

b. The Focus Of The Exception Is On The Objective Conduct Of The Creditor And Debtor, In The Context Of Industry Standards.

The three-part test of section 547(c)(2)—ordinary debt, ordinary payment, according to ordinary business terms—has neither an express nor implied requirement of balance sheet neutrality. Nothing in the statute requires proof that the challenged payment did not diminish the assets of the debtor. The ordinary course of business exception examines in the first instance the *conduct* of the creditor and debtor, and *refuses to protect payments which are the result of unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy*. Payments which would otherwise constitute avoidable preferences are, however, protected if the objective facts surrounding the transactions and the observable history of the parties' dealings indicate that the creditor and debtor conducted themselves in a constructive, fair manner during the preference period.

This focus on *conduct* has been the hallmark of the analysis of the avoidability of ordinary course of business payments throughout the history of the bankruptcy laws of the United States. As set forth more fully below, the earliest preference statutes permitted the recovery of preferences only if the trustee could prove that the creditor had reasonable cause to believe that he was receiving a preference (under the 1898 Act[5]) or reasonable cause to believe that the debtor was insolvent at the time of payment (under the 1938 Chandler Amendments to the former Bankruptcy Act). *See* 3, pt. 2 Collier on Bankruptcy ¶ 60.06 at 779 n. 13 (14th ed. 1977) (detailing changes in preference statute effected by 1938 amendments).[6] Although there was no *express* exception for ordinary course payments, the issue arose under these versions of the preference statute because the receipt of such payments was consistent with the behavior of a creditor who had no reason to believe that the debtor was favoring him or that the debtor was insolvent. Similarly, payments not in the ordinary course of business were evidence of improper intent.

Today, under the Bankruptcy Code, a trustee no longer must prove that the creditor knew or should have known that his debtor was favoring him or was

[5] Bankruptcy Act of 1898, 30 Stat. 544 (as amended) (repealed), *reprinted in* 10 Collier on Bankruptcy 1783 (14th ed. 1977).

[6] The focus on the creditor's reasonable state of mind predated even the 1898 Bankruptcy Act. The Bankruptcy Act of 1867 required the trustee to prove that the creditor "had reasonable cause to believe that (1) such person was insolvent and that (2) such transfer was in fraud of the act." 3, pt. 2 Collier on Bankruptcy ¶ 60.05 at 770-71 (14th ed. 1977).

insolvent. As one of the leading bankruptcy treatises explains:

> *intent* or *motive* is not a material factor in the consideration of an alleged preference under § 547. Generally speaking, it is the *effect* of a transaction, rather than the debtor's or creditor's intent, that is controlling.

4 Collier on Bankruptcy ¶ 547.01 at 547.12 (15th ed. 1991). The preference statute is, thus, a strict liability statute which focuses on the *effect* of the pre-petition payments rather than on the *intentions* of the debtor and creditor.

The ordinary course of business exception, however, provides an important counterbalance to this strict liability, effect-oriented scheme by permitting a creditor to defend against a preference action by showing that, by virtue of the objective "ordinariness" of the transactions and payments, the creditor did not engage in a race of diligence and the debtor did not attempt to prefer him over other creditors. Thus, while intent is no longer relevant, the deterrence policy of the preference statute is advanced. The creditor is permitted to show that the objective, observable *conduct* of the parties comported with the constructive, fair behavior the preference statute is designed to induce.

No doubt, the burden of proof has shifted from the trustee to the creditor, 11 U.S.C. § 547(g) (1979 & Supp. 1991), but the issue of the conduct of the parties remains relevant to the determination of whether a pre-petition payment is an avoidable preference. The exception is a limited trade-off of the trustee's power to recover otherwise preferential payments in the hope

that, as a result of the exception, creditors and debtors will conduct themselves in a fair and constructive manner so that fewer bankruptcies will occur.

c. The Policy Of The Ordinary Course Of Business Exception Is Supported By Extending It To Long-Term Debt.

Viewed in this context, the question whether the ordinary course of business exception is available to creditors who received payments on account of long-term debt leads to an entirely different answer from that given by the Ninth Circuit. Aggressive creditor action is *at least* as deleterious to a troubled company when the creditor is the holder of a long-term debt instrument as when the creditor is a short-term trade supplier. A debtor's long-term loans are often the largest debts it owes and these loans often constitute or are tied to revolving or operating lines of credit needed by the borrower to remain in business.

Indeed, in modern commercial finance, the debtor's long-term lender is often the debtor's single most important "supplier." Many long-term loans are revolving lines of credit in which the debtor receives new funds, at its discretion, in exchange for continued timely interest payments to the lender. That is to say, the debtor's regular timely payments of interest are the condition precedent to the continued availability of credit under the line. Because such payments are made to the bank, the debtor has the ability to make new draws on the line—draws which can well exceed the amount of the regular timely payments of interest made by the debtor during the same time period.

Such payments do not diminish the estate. Rather, they enhance the working capital of the debtor

and can be the lifeblood of the debtor's efforts to remain in business. Nonetheless, the Ninth Circuit in the case below "fail[ed] to see any significant difference between a revolving line of credit and an ordinary loan for purposes of § 547(c)(2)." *In re ZZZZ Best Co.*, 921 F.2d at 969. In this regard, the Ninth Circuit misapplied even on its own incorrect analysis by failing to see that a long-term commercial lender on a revolving line of credit can be an important "supplier" of the very capital a debtor needs to buy goods and services and remain a viable member of a productive economy.

It is unclear why Congress initially imposed the 45-day limitation in the 1978 codification of the ordinary course of business exception. No legislative history addresses this feature of the legislation. The 45-day limitation had no antecedent in either the case law construing or the language of the former Bankruptcy Act. The limitation was deleted in 1984, again with sparse legislative history to explain the purpose of the deletion.

Whatever the reasons, the policies expressed by the ordinary course of business exception can be applied to long-term credits, as well as short-term credits. There is no ambiguity in the language of the exception, the policy supporting the exception applies with at least equal force to both types of credits, and enforcing the statute as written is entirely consistent with the overall purposes of the preference statute.

III
THE ORDINARY COURSE OF BUSINESS ISSUE HISTORICALLY HAS RELATED TO THE DETERRENCE POLICY OF THE PREFERENCE STATUTE.

a. Cases In General.

The history of the preference statute since the 19th century has been one of the balancing and refinement of rules to further two complementary policies: preventing the "race of diligence" and maximizing equality of distribution. House Report 178. The ordinary course of business issue has been an express part of this policy since at least the Bankruptcy Act of 1867, 14 Stat. 517, as amended, (repealed by Act of June 7, 1878, 20 Stat. 99), *reprinted in* 10 Collier on Bankruptcy 1747 (14th ed. 1977). Section 35 of that act provided that a transfer during the four months prior to bankruptcy could be avoided by the trustee upon proof of the transferor's fraudulent intent and that "if such . . . transfer . . . is not made in the usual and ordinary course of business of the debtor, the fact shall be prima facie evidence of fraud." *Id.* at 1768-69.

Initially, the deterrence policy had a predominant effect on the outcome of preference actions, because the trustee was required to prove as part of his *prima facie* case that the creditor knew or should have known that it was (under the 1898 Act) receiving a preference[7] or (under the 1938 Chandler

[7] Section 60b of The Bankruptcy Act of 1898 required proof by the trustee that "the person receiving [a challenged transfer] . . . shall then have such reasonable cause to believe that the [receipt of such transfer] would effect a preference." 10 Collier on Bankruptcy

Amendments to the former Bankruptcy Act) taking a payment from an insolvent. Thus, section 60b of the former Bankruptcy Act, 11 U.S.C. § 60b (1970), provided that a preference "may be avoided by the trustee if the creditor receiving it or to be benefitted thereby or his agent acting with reference thereto has, at the time when the transfer is made, *reasonable cause to believe that the debtor is insolvent.*"(emphasis added). *See* 3, pt. 2 Collier on Bankruptcy ¶ 60.52[1] 1051 (14th ed. 1977). The trustee had the burden of proof on this issue. *Vance v. Dugan,* 187 F.2d 605 (10th Cir. 1951), 3, pt. 2 Collier on Bankruptcy ¶ 60.54[1], at 1075 (14th ed. 1977).

This element of the *prima facie* case was troubling to the drafters of the 1978 Bankruptcy Code because proof of the element was difficult, even though the test was expressed in terms of the creditor's "reasonable cause to believe," rather than actual state of mind. House Report 178. Moreover, the House Report explained that the focus on the debtor's reasonable state of mind furthered only the deterrence policy, not the equality of distribution policy of the preference statute. *Id.* Accordingly, the preference section of the former Bankruptcy Act was replaced in the Code with a provision that eliminated the reasonable cause to believe element from the trustee's case in chief.[8]

1783, 1816 (14th ed. 1977).

[8] The requirement was deleted in two phases. Initially, such proof was required only for preference actions against an insider during the period between 90 days and one-year preceding the filing of the bankruptcy petition. Bankruptcy Reform Act of 1978, Pub.L. 95-598, 92 Stat. 2549 at 2598 (enacting and codifying 11 U.S.C. §

It is important to recognize, however, that the new formulation of the preference statute did not abandon all inquiries into the conduct of the debtor and its creditors. That is to say, the new formulation did not abandon the policy of deterring the race of diligence. On the contrary, the question of the parties' conduct was removed from the case in chief and made part of the affirmative defenses, or exceptions, to the preference claim.

This is perhaps best demonstrated by an examination of how courts employed the concept in preference actions under the former Bankruptcy Act, before the concept was codified as a preference exception in the 1978 Code. *See Midlantic Nat. Bank v. New JerseyDep't of Env. Protection,* 474 U.S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific."). Under the former Bankruptcy Act, a creditor could defend against any showing by the trustee that a creditor had reasonable cause to believe that the debtor was insolvent by submitting evidence that the payment was received in the ordinary course of business:

> Payments received by a creditor in the ordinary course of business with an insolvent debtor are not necessarily

547(b)(4)(B)(ii) (prior to 1984 amendment). No such proof was required during the 90-day preference period applicable to all creditors. *Id.* Later, the "reasonable cause" element was entirely deleted. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. 98-353 § 462(b), 98 Stat. 333, 378 (amending 11 U.S.C. § 547(b)(4)(B)).

> voidable. The acceptance of payments with no special purpose of obtaining advantage over other creditors but in accordance with the creditor's general method of collecting outstanding accounts will not give rise to reasonable cause to believe that the debtor is insolvent.

3, pt. 2 Collier on Bankruptcy ¶ 60.54[4], 1082.1. (14th ed.). Indeed, this Court has long recognized that the reasonable cause to believe element of the old preference action could be established by the mere proof that a transfer was not made in the ordinary course of business. *Wager v. Hall,* 83 U.S. (16 Wall.) 584, 600 (1873) ("It is prima facie evidence of [transferee's reasonable cause to believe transferor was insolvent at time of transfer] if the conveyance is not made in the usual and ordinary course of business of the debtor.")

Thus, in the case of *In re First National Bank of Louisville,* 155 F. 100, 104 (6th Cir. 1907), a case under the 1898 Act, the court held that the trustee had failed to prove the creditor had reasonable cause to believe that the debtor intended a preference because a creditor "may well suppose that the debtor while paying him his debt in the common course of business is acting without any purpose of giving special favor." Similarly, in *Grandison v. Robertson,* the court reasoned:

> The Bankruptcy Act does not take away from a banker the right to transact business with his customer in the ordinary way. He may take renewal notes in extension of credit and receive

> partial payment of his debt, and has the right during the continuance of their relations to presume that his debtor is solvent and carrying on business in the usual way; and if it turns out that the debtor was insolvent the creditor may receive payment without incurring the liability of having to restore such payment when bankruptcy intervenes.

220 F. 985, 987 (W.D.N.Y. 1915), *modified on other grounds,* 231 F. 785 (1916). And in *Miceli v. Morgano,* 36 F.2d 507 (W.D.N.Y 1929) the court wrote that it "has frequently been decided that mere suspicion is not enough to put a creditor on inquiry as to the financial condition of this debtor, and charge him, upon the payment of his account in the ordinary course of business, with reasonable cause to believe that a preference over other creditors was given to him." *Id.* at 509. The case of *In re Singer & Sirotta, Inc.*, 27 F. Supp. 276 (S.D.N.Y.1939), is to like effect. There, the district court reversed a bankruptcy referee's finding that no preference had been paid where, *inter alia*, the "payments were not in the ordinary course of business." *See also Burk v. Musk,* 51 F.2d 581 (E.D. Ill. 1931) ("The unusual nature of the transaction, in connection with all the circumstances, raises such a presumption that it can only be overcome by proof on the part of the preferred creditor that he took the proper steps to find out the pecuniary conditions of the debtor."), *aff'd* 58 F.2d 77 (7th Cir. 1932).

More recently, in the case of *Holahan v. Gore,* 278 F. Supp. 899, 902-03 (E.D. La. 1968), the court wrote that the "usual or unusual nature of the transfer" is one of the factors to be considered in determining

whether the creditor had reasonable cause to believe the debtor was insolvent. And in *Katz v. First Nat'l Bank of Glen Head,* 568 F.2d 964 (2d. Cir. 1976), *cert. denied,* 434 U.S. 1069 (1978), the Court reversed and remanded for trial the question whether a build-up of deposits by a debtor in a bank account with his creditor bank was made in the ordinary course of business (and therefore not a transfer) or with the intention of making the deposits available for set-off by the bank. *Id.*, at 971 ("Here the trustee alleged facts from which it couild be inferred that the bankrupt did not make the deposits in its Glen Head account in good faith; that the deposits were not made in the regular course of its business . . .").

Thus, contrary to the Ninth Circuit's analysis, the ordinary course of business test was not created out of whole cloth by the 1978 Bankruptcy Code. It has been part of the fabric of the preference statute since at least the 1860's. Originally, it was raised in connection with the trustee's attempt to meet his burden of proof that the creditor knew or should have known that it was receiving a preference. The change effected by the Bankruptcy Code was simply to remove it from the case in chief and put it into the creditor's affirmative defenses. *See* 11 U.S.C. § 547(g) ("The creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section.").

This shifting of the burden of proof, however, did not change the essential purpose of the exception. The ordinary course of business exception focuses on the objective *conduct* and prior course of dealings of the parties for the same reason that the "reasonable

cause to believe" element focused on the state of mind of the creditor: to prevent the race of diligence. Of course, preventing the race of diligence has significant positive consequence for the viability of the debtor generally. Even if the debtor is unable to avoid bankruptcy, the measured conduct of its creditors before bankruptcy could well leave the estate in a better position to distribute more assets to its creditors in an equitable fashion. Thus, the ordinary course of business defense is consistent with the equality of distribution goals of the preference statute. Fundamentally, however, examining whether a payment is made on account of an ordinary debt, in the ordinary course of business of the debtor and creditor and according to ordinary business terms goes to the issue of preventing the race of diligence.

b. Under Former Bankruptcy Act, The Ordinary Course Of Business Issue Arose In Cases Involving Credits Of Every Nature. The Issue Was Not Limited to Trade Or Other Short-Term Creditor Cases.

There appears to be no decisional or statutory authority under the former Bankruptcy Act which even suggests that the ordinary course of business issue was relevant only in short-term or trade credit situations. Rather, the cases span a multitude of fact patterns, including short and long-term debt, in a range of commercial contexts. For example, in *In re First National Bank of Louisville*, 155 F. 100, the challenged payments were made to a bank on a series of loans

secured by accounts receivable.[9] *Grandison v. Robertson*, 220 F. 985, involved commercial loans by private bankers secured by accounts receivable and initially made over one year before the debtor became insolvent.[10] In *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964, the recipient was a bank which had made a solitary advance over two and one half years before the debtor filed bankruptcy! In each case the courts' preference analysis looked to whether the challenged payments were made in the ordinary course of business. No question was even raised whether it was appropriate to do so for payments on account of such apparently long-term credits.

CONCLUSION

There is simply no support for the Ninth Circuit's ruling that the ordinary course of business exception applies only to short-term credit transactions. The legislative history does not support the ruling and the pre-Code case law and bankruptcy statutes argue

---

[9] Although the loans in the *First National Bank* case were executed in a series of transactions, the substance of the loans appears to have been virtually identical to a revolving line of credit, a credit which the Ninth Circuit has concluded is not within the ambit of the ordinary course of business exception.

[10] In *Grandison* the court found that the bankruptcy preference statute had not been violated because the private bankers had no reasonable cause to believe that the debtor was insolvent. The payments were nonetheless recovered by the trustee under a state law preference statute which expressly focused only on the intention of the debtor, not the transferee. *Grandison v. Robertson*, 220 F. at 988-99.

strongly for the contrary position. The ordinary course of business issue has long been part of the preference law of the United States and it has been consistently invoked to create incentives against the race of diligence. The Ninth Circuit's rule would eliminate an important incentive for banks and other commercial lenders to maintain credit availability for and work with borrowers who, though weakened, are able to continue to make ordinary course payments. This incentive is important both to banks and to debtors, especially those who are party to revolving line of credit agreements.

The decision below should be reversed.

Dated: July 8, 1991

Respectfully submitted,

Robert L. Morrison
Counsel of Record
Kenneth N. Russak
PILLSBURY MADISON
& SUTRO
Attorneys for *Amicus Curiae*
CALIFORNIA BANKERS
ASSOCIATION

No. 90-1491

In The

Supreme Court of the United States

October Term, 1991

UNION BANK,

Petitioner,

vs.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF ROBERT MORRIS ASSOCIATES AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

RAYMOND K. DENWORTH, JR.
Counsel of Record
ANDREW C. KASSNER
SHEILA OLIVER
DRINKER BIDDLE & REATH
1100 Philadelphia National Bank Building
Broad and Chestnut Streets
Philadelphia, Pennsylvania 19107
(215) 988-2700

Attorneys for
Robert Morris Associates as Amicus Curiae

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES – Continued

TABLE OF AUTHORITIES – Continued

INTERESTS OF AMICUS CURIAE

Robert Morris Associates submits this *amicus curiae* brief in support of the Petitioner in this case, with the written consent of both Petitioner and Respondent.

Robert Morris Associates is a national association of bank loan and credit officers. Its membership numbers nearly 3,000 banks and thrifts, and represents 75% of all commercial and industrial loans extended by the United States banking industry. The purpose of Robert Morris Associates is to foster superior standards and performance in the practice and management of lending and credit activities.

Long term lenders, including the nation's commercial banks, will be severely disadvantaged by the precedent established by the Ninth Circuit's decision, and if that precedent stands, banks will have to factor into their assessment of credit risk an element of additional loss. Since that would be difficult in all cases and impossible in some, the cost of borrowing would be increased, or credit would be denied. There is no indication that any such result was intended by Congress, and Robert Morris Associates believes that Congress, not the judiciary, should establish the national bankruptcy policies which have such significant repercussions for both borrowers and lenders.

STATUTES INVOLVED

This case requires interpretation of Section 547 of the Bankruptcy Code.

Section 547(b) (the "preference provision") provides:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property –

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made –

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would have received if –

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Section 547(c)(2) (the "ordinary course of business exception" or the "ordinary course of business defense") provides:

The trustee may not avoid under this section a transfer –

. . . .

(2) to the extent that such transfer was –

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms.

Section 547(c)(2) of the Bankruptcy Code was amended in 1984. Prior to amendment, Section 547(c) contained an additional provision (the "45-day rule"), which provided:

(2) to the extent that such transfer was . . .

(B) made not later than 45 days after such debt was incurred . . .

Congress deleted former Subsection 547(c)(2)(B) in its entirety by the passage of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Amendments").

SUMMARY OF THE ARGUMENT

The Ninth Circuit is in error when it holds that, as a matter of law, the ordinary course of business exception to preference avoidance does not extend to payments made on long term debt, notwithstanding the plain meaning of the statute. Since its amendment in 1984, Section 547(c)(2) of the Bankruptcy Code has contained no language that distinguishes between long and short term debt. As such, the plain meaning of the statute is that the defense now applies equally to all creditors, regardless of the nature of the indebtedness.

Removing the time limit from the ordinary course defense, thereby extending the defense to payment on all debt both short and long term, is not at odds with the intention of the drafters of the Bankruptcy Code. The purpose of preference law is to provide equitable distribution to creditors and to encourage extension of credit to potential debtors. The purpose of the ordinary course of business exception to preference recovery is to preserve normal financial relations. The preservation of normal financial relations does not conflict with the purposes of equitable distribution and credit extension, but merely limits their application. The current restrictions on the ordinary course defense which remain after the deletion of the 45-day rule balance these policy objectives *and* realize the intentions of the drafters of the Bankruptcy Code.

This Court should apply its recent analysis of the plain meaning rule and the Bankruptcy Code, in *Toibb v. Radloff*, 59 U.S.L.W. 4633 (1991) and *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989), to this case. The Ninth Circuit incorrectly recognized an exception to the plain meaning rule in interpreting the Bankruptcy Code. This exception provides that courts should not interpret the Code to change longstanding principles of bankruptcy law created by the courts unless Congress indicates an intent to change the law. In this case, a plain reading of the statute does not improperly preempt states' rights, expand bankruptcy avoidance powers, or change longstanding or judicially created principles of bankruptcy law. Furthermore, the plain meaning of the deletion of the 45-day rule is sufficient evidence of Congress' intent to change the law.

The courts should not read a distinction between long and short term debt into the plain meaning of the statute because any distinction depends on policy determinations better left to the legislature. Congress was familiar with a broad spectrum of distinctions between long term and short term debt, but did not elect to include *any* of these distinctions when it amended the statute. Congress is in a better position than the courts to decide if any distinction belongs in the statute, and it chose *not* to include such a distinction in enacting the 1984 Amendments that eliminated the 45-day rule.

Courts and commentators have read a multiplicity of conflicting and inconsistent distinctions into the statute. This confusion certainly does not further any important bankruptcy policies and is at odds with the intent of the drafters. This Court should enforce the plain meaning of the statutory language that Congress has provided and eliminate the long term – short term distinction now plaguing the interpretation of the Bankruptcy Code.

ARGUMENT

I. THE PLAIN MEANING OF THE STATUTE APPLIES EQUALLY TO ALL CREDITORS.

A. The Plain Meaning of the Amended Statute Removes All Distinction Between Long Term Debt and Short Term Debt from Section 547(c)(2) of the Bankruptcy Code.

The Ninth Circuit has held as a matter of law that the ordinary course of business exception to preference recovery does not extend to payments made on long term

debt. *In re ZZZZ Best*, 921 F.2d 968, 969 (9th Cir. 1990), *cert. granted*, 59 U.S.L.W. 3769 (1991); *Matter of CHG International, Inc.*, 897 F.2d 1479, 1482 (9th Cir. 1990). The question before the Court is whether Section 547(c)(2) of the Bankruptcy Code distinguishes between long term debt and short term debt. The plain meaning of Section 547 answers this question. Since the passage of the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-433, 98 Stat. 333, Section 547 has contained no limiting language on the type of debt protected by the ordinary course of business defense to preference recovery. The defense now applies equally to all creditors, regardless of the type of debt involved, if the creditor satisfies the requirements of Section 547(c)(2)(A)-(C) of the Bankruptcy Code.

The plain meaning rule of statutory construction requires that statutory interpretation begin with the statute itself. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985). Only if the statutory language is unclear should the Court look to legislative history. *Toibb v. Radloff*, 59 U.S.L.W. 4633, 4634 (1991) (quoting *Blum v. Stenson*, 465 U.S. 886, 896 (1984)). The language of Section 547(c)(2), which defines payments to be excluded from the ordinary course exception on the basis of the type of debt or the repayment terms, is not unclear. There is *no* language in the statute purporting to create this distinction, and the natural interpretation therefore must be that the statute does not create such a distinction.

No one now argues that, as the result of the deletion of 45-day rule from the ordinary course of business exception, the rule still applies. The holding of the Ninth Circuit, however, assumes that Congress intended to retain a distinction between short term and long term debt in the statute, despite Congress' refusal to replace the 45-day rule with any other time limitation. The Ninth Circuit errs in assuming this distinction, because Congress knows how to write limiting language into the Bankruptcy Code if that is its intent. *See, e.g., Toibb*, 59 U.S.L.W. at 4634 (Congress knows how to restrict access to bankruptcy relief); *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, n.5 at 242 (1989) (if Congress intended to limit application of Code provision, it would have clarified by using specific phrase). *See also Offshore Logistics, Inc. v. Tallentire*, 477 U.S. 207, 222 (1986) (when Congress wants to preserve a right, it does so expressly). If Congress did not want the deletion to result in the elimination of the concept of short term debt from Section 547(c)(2), Congress could have included a proviso to that effect. *See, e.g., National Woodworkers Manufacturers Association v. N.L.R.B.*, 386 U.S. 612, 632 (1967) (Congress maintains important distinction after deletion of limiting language by adding additional limiting language in same section).

If Congress had written an alternative time limit or a vaguely worded distinction between short and long term debt into the statute to replace the 45-day rule, the resulting statutory language might have been unclear. Indeed, the struggle of the courts to define long term and short term debt (despite the absence of those terms in the statute) suggests that these terms do not have a plain meaning. While almost any word or phrase might be held to be ambiguous, deletion and the resulting *absence* of words are subject to far less misinterpretation.

The total deletion of a statutory provision is not likely to be simply an omission. Even if, however, the

absence of limiting language to replace the deleted 45-day rule in the amended statute represents a congressional oversight, it is not the role of the judiciary to write limiting language back into the statute. If Congress merely "forgot" to define the difference between long term and short term debt in the ordinary course exception, the courts should not ask how Congress would have defined it had they actually considered the question. *West Virginia University Hospitals v. Casey*, 59 U.S.L.W. 4180, 4185 (1991) (when issue is merely difference between more parsimonious policy of earlier enactment and more generous policy of later one, judges should not prescribe one policy on basis of congressional "forgetfulness"). Instead, this Court should acknowledge that a straightforward reading of the amended statute extends the ordinary course defense to all creditors if they satisfy the remaining statutory requirements.

The Ninth Circuit held that, despite the fact that Congress has deleted the limiting language in Section 547(c)(2), the statute continues to impose a short term debt limitation, because protection of long term creditors would be against congressional bankruptcy policy. *Matter of CHG International, Inc.*, 897 F.2d at 1485. In rare cases, the literal application of a statute may produce a result demonstrably at odds with the intentions of its drafters, and in those cases the drafters' intentions must be controlling. *Ron Pair*, 489 U.S. at 242 (citing *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)). In this case, however, the result of the literal application of the amended language of Section 547 is that all debt payments that are made in the ordinary course of business

are protected from preference actions by a trustee, and this result does *not* defeat the intentions of Congress when it enacted the Bankruptcy Code.

B. Removing the Time Limit is Not at Odds With the Intentions of the Drafters of the Bankruptcy Code.

The Ninth Circuit holds that the removal of all distinctions between long and short term debt undermines congressional policies underlying the preference provisions of the Bankruptcy Code. *Matter of CHG International, Inc.*, 897 F.2d at 1482-83. This view misinterprets the intention of the Bankruptcy Code's drafters. The inclusion of all payments to creditors which have been made in the ordinary course of business (as measured by the statutory requirements of 547(c)(2)) does not undermine the bankruptcy policies which Congress sought to advance in the 1978 Bankruptcy Code by enacting the ordinary course exception to preferences, the preference powers themselves, or the Bankruptcy Code as a whole.

The enactment of the Bankruptcy Code did not merely codify existing bankruptcy law on preference avoidance, but worked significant changes in this area. No distinction between long term and short term debt existed under the Bankruptcy Act, under which payments to creditors were not avoidable as preferences unless the creditor had "reasonable cause to believe" that the debtor was insolvent and the debtor could demonstrate that it was insolvent at the time of the transfer. 11 U.S.C. §60(a) (repealed 1978). As such, under the Act, payments on *both*

long term and short term debt could be protected from preference recovery.[1]

The "reason to believe" standard was onerous and Congress specifically intended to remove it from bankruptcy law when it enacted the 1978 Bankruptcy Code. H.R. Rep. No. 595, 95th Cong., 1st Sess. 178-79 (1977). To do so, Congress devised a new structure for the preference statute. Under the 1978 Bankruptcy Code, knowledge of the debtor's insolvency was no longer relevant and the debtor was presumed insolvent. Pre-bankruptcy payments were presumed to be preferences if the other statutory elements were satisfied. Congress created a series of defenses as a limitation to preference avoidance to replace the subjective "reasonable cause to believe" limit and the trustee's burden of proof of insolvency in the Act.[2]

The plain language of Section 547(c)(2) after the 1984 Amendments does not defeat the intent of Congress in

[1] Even if a creditor had "reasonable cause to believe" that the debtor was insolvent and still accepted payment, bankruptcy courts provided further protection by developing the "current expense" rule. The rule allowed payments for current operating expenses of the debtor to be exempted from preference treatment. The current expense defense by its terms applied almost exclusively to trade creditors.

[2] These defenses include the "contemporaneous exchange" defense, 11 U.S.C. §547(c)(1), the "new value" defenses, 11 U.S.C. 547(c)(3) and (4), the "inventory" defense, 11 U.S.C. §547(c)(5), the "statutory lien" defense, 11 U.S.C. §547(c)(6), the "consumer" defense, 11 U.S.C. §547(c)(7), and "the ordinary course of business" defense, 11 U.S.C. §547(c)(2).

granting preference powers to the trustee. The Ninth Circuit states that the preference provisions were intended to further the policy of equitable distribution to creditors of a bankruptcy estate. *Matter of CHG International, Inc.*, 897 F.2d at 1482. However, the principle of equitable distribution taken to its extreme would require that all pre-bankruptcy payments should be preferences, because *any* payment to a creditor benefits that creditor to the detriment of other creditors who will be paid less upon liquidation of the bankrupt estate.

Obviously, Congress did not intend this one policy to prevail to the exclusion of other important bankruptcy policies. This is evident from Section 547(c), which provides several exceptions to preference avoidance, including the ordinary course exception. All of these exceptions protect payments to creditors made within ninety days[3] before the bankruptcy filing. These exceptions embody a separate but equally important bankruptcy policy that bankruptcy avoidance powers should not disturb normal financial relations. H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990); S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* App. 3 COLLIER ON BANKRUPTCY ch. V (15th ed. 1990). The sum effect of these exceptions is that many transactions are excluded from preference attack.[4]

[3] Payments made up to one year prior to bankruptcy filing to *insiders* are eligible for preference recovery. 11 U.S.C. §547(b)(4)(A).

[4] *See, e.g., Levit v. Ingersoll Rand Financial Corp. (In re DePrizio)*, 874 F.2d 1186, 1199 (7th Cir. 1989) (most ordinary commercial transactions exempt from recovery under Section 547).

Another purpose that the courts ascribe to the preference provisions is to encourage extension of credit to potential debtors to forestall the slide into bankruptcy. The Ninth Circuit concluded that making long term debt eligible for ordinary course treatment does not further this policy. *Matter of CHG International, Inc.*, 897 F.2d at 1483. No showing has been made, however, that short term credit is the only credit that a financially distressed company requires to avoid the slide into bankruptcy. Nothing in the legislative history of the 1978 Bankruptcy Code or the 1984 Amendments compels the conclusion reached by the Ninth Circuit that the continuation of a debtor's long term debt relationships will not aid the debtor in avoiding a slide into bankruptcy.

Congress intended the ordinary course exception to preserve normal financial arrangements and to protect the bankrupt estate from diminution due to extraordinary measures taken by either creditor or debtor in response to the debtor's deteriorating financial condition. H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* App. 2 Collier on Bankruptcy ch. II (15th ed. 1990); S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* App. 3 Collier on Bankruptcy ch. V (15th ed. 1990). The plain language of Section 547(c)(2) does not defeat Congress' original intent in drafting the ordinary course of business exception. By creating the ordinary course defense (in addition to the numerous other defenses to preference actions), Congress intended preference avoidance by the trustee to be the exception, not the normal treatment of payment to creditors during the period prior to the filing of a bankruptcy case.

The implied rationale of the Ninth Circuit's ruling is that the elimination of any distinction between long and short term debt will cause the ordinary course exception to "swallow" the preference powers of the trustee. But the ordinary course exception to the preference provision, as it is now written, does not protect *all* payments to creditors in satisfaction of long or short term debt. The remaining requirements of the ordinary course exception continue to define the boundaries of the exception. If payments on long term debt do not satisfy *all three* elements of the ordinary course exception, such payments will not be protected by Section 547(c)(2). Consequently, elimination of the 45-day rule *more accurately* reflects the congressional intent of deterring only exceptional, bankruptcy-driven transfers than the former 45-day limitation.

Congress may seek to achieve more than one purpose in drafting provisions of the Bankruptcy Code. *Toibb v. Radloff*, 59 U.S.L.W. at 4635. The purpose of preserving normal financial relations does not conflict with the policies of equitable distribution to creditors and encouragement of short term credit, but merely *limits* their application. Thus, application of Section 547(c)(2) according to its plain meaning accurately implements the legislative policy behind the ordinary course exception.

C. The Analysis of the Plain Meaning Rule in *Toibb* and *Ron Pair* Applies to this Case.

The Ninth Circuit reaches its holding that Section 547(c)(2) applies only to payments on short term debt by attempting to apply an exception to the plain meaning rule. *Matter of CHG International, Inc.*, 897 F.2d at 1484

(significant shift in congressional policy not presumed without legislative history as to intent). This exception, as applied to the Bankruptcy Code, requires that courts should not interpret the Bankruptcy Code to change longstanding principles of bankruptcy law created by the courts unless Congress indicates its intent to change the law.[5] This exception to the plain meaning rule does not apply to this case for two reasons. First, the distinction between short and long term debt is neither judicially created nor of long standing. The short term debt limitation was an innovation introduced by the drafters of the 1978 Bankruptcy Code. Second, the deletion of *any* reference to time limits in the amended statute is a sufficiently explicit indicator that Congress intended to change the law to eliminate any distinction between long and short term debt.

In *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494 (1986), a bankruptcy trustee sought to abandon property of the estate in contravention of state environmental laws. The Court declined to apply the plain meaning of the abandonment provisions of the Bankruptcy Code, and held that, without evidence of specific congressional intent to change the law, the Bankruptcy Code should not be applied to lift long-standing judicial restrictions on the trustee's abandonment powers, thereby granting a bankruptcy trustee "an extraordinary exemption from non-bankruptcy law." 474 U.S. at 501.

---

[5] *See, e.g., United Savings Associates of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 380 (1988) (major change in existing rules is unlikely without specific provision in text of statute); *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, n. 3 at 203 (1988) (judicially created exception to absolute priority rule may survive codification by Congress).

In *Kelly v. Robinson*, 479 U.S. 36 (1986), the Court addressed the exclusion of criminal fines from discharge in bankruptcy. This exclusion appeared nowhere in the language of the Act. However, the Court noted, "despite the clear statutory language [of the Act] [discharging criminal fines], most courts refused to allow a discharge in bankruptcy to affect the judgment of a state criminal court." 479 U.S. at 45. This became a widely accepted judicial exception to the language of the Bankruptcy Code as well. 479 U.S. at 46. The Court held that "in light of the strong interests of the States, the uniform construction of the old Act over three-quarters of a century, and the absence of any significant evidence that Congress intended to change the law in this area, we believe [reading the exception into the Code] best effectuates the will of Congress." 479 U.S. at 53.

The justification used by the Court in *Kelly* and *Midlantic* for reading language into the Bankruptcy Code not expressly stated in the statute does not apply to the ordinary course exception, as amended by the 1984 Amendments, at issue in this case. First, increased protection of creditors' rights under federal bankruptcy law does not intrude on the interests of the states or grant the debtor "an extraordinary exemption from non-bankruptcy law." Second, long term debt has not been excluded from protection as a longstanding or judicially created construction of preference law. To the contrary, prior to enactment of the Bankruptcy Code, payments on long term debt were not routinely treated as preferences because under the Act the distinguishing factor was "reasonable cause to know." This distinction was intentionally eliminated by enactment of the Bankruptcy Code

and introduction of a new statutory scheme: a presumption of insolvency and therefore a presumption of preference, limited by several defenses. Pre-Code practice is not relevant in this case, as it was in *Kelly* and *Midlantic*, because the Bankruptcy Code had already explicitly changed the preference law.

Kelly further requires significant evidence that Congress intended to change the law. Congress has changed the preference law twice, first with the enactment of the Bankruptcy Code, which limited the ordinary course exception to extremely short term debt, and again with the 1984 Amendments, when the 45-day limitation was removed. Deletion of the 45-day rule without *any* limiting language to replace it is significant evidence that Congress intended to eliminate any distinction between short and long term debt.

In *United States v. Ron Pair Enterprises, Inc.*, the Court delineated the limits of the exception to the plain meaning rule applied in *Kelly* and *Midlantic*, in interpreting the plain meaning of Section 506 of the Bankruptcy Code which provides for post petition interest on secured claims. The Court noted that *Kelly* and *Midlantic* involved:

> statutory language which, at least to some degree, was open to interpretation. Each involved a situation where bankruptcy law, under the proposed interpretation, was in clear conflict with state or federal laws of great importance. In the present case, in contrast, the language in question is clearer than the language at issue in *Midlantic* and *Kelly*: as written it directs that postpetition interest be paid on all oversecured claims. In addition, this natural interpretation of the statutory language does not conflict with any significant state or federal interest, nor with any other aspect of the Code. Although the payment of postpetition interest is arguably somewhat in tension with the desirability of paying all creditors as uniformly as practicable, Congress expressly chose to create that alleged tension. *There is no reason to suspect that Congress did not mean what the language of the statute says.*

489 U.S. at 245-46 (emphasis added).

In *Toibb v. Radloff*, the Court recently examined and applied the plain meaning rule again in interpreting the Bankruptcy Code. In *Toibb*, the Court held that individual debtors are eligible to file for relief under Chapter 11, because the language of Section 109 of the Bankruptcy Code does not expressly exclude individuals from Chapter 11 eligibility. 59 U.S.L.W. at 4634. In response to the argument that the legislative history did not affirmatively reflect Congress' intent to include individual debtors in Chapter 11, the Court held that the legislative history need not affirmatively reflect legislative intent where the plain language of the statute itself evinces the intent.[6] 59 U.S.L.W. at 4635.

---

[6] *See also Pennsylvania Dept. of Public Welfare v. Davenport*, 58 U.S.L.W. 4610 (1990), where the Court overrode a judicially created exception to the Bankruptcy Code because the plain language of the statute indicated Congress' intent. 58 U.S.L.W. at 4613.

The Court's application of the plain meaning rule to the Bankruptcy Code in *Ron Pair* and *Toibb* more accurately interprets the amended ordinary course exception than the restrictive approach that the Court took in *Kelly* and *Midlantic*. The 45-day rule was not bankruptcy law of long standing; it was an innovation of the 1978 Bankruptcy Code. By eliminating the 45-day rule entirely from the statute and not replacing it, Congress sent a clear signal that the ordinary course exception no longer makes any distinction between long and short term debt.

II. THIS COURT SHOULD NOT ENGAGE IN JUDICIAL LEGISLATION BY DEFINING LONG TERM DEBT.

A. Congress Must Balance Interests and Formulate Policy.

It is well established that it is the exclusive province of Congress to formulate policies and balance competing interests in enacting legislation. *Tennessee Valley Authority v. Hill*, 437 U.S. 153, 194 (1978). Unlike Congress, the courts do not have the expert knowledge, resources, i procedures to investigate and weigh competing interests and enact policy initiatives. 437 U.S. at 194. Even where a sound policy basis exists for reading limiting language into a statute, it is Congress which must rewrite the statute, and it is unjustifiable for the courts to attempt to do so by a process of "judicial legislation." *Southern Motor Carriers Rate Conference v. United States*, 471 U.S. 48, 78 (1985) (quoting *United States v. Trans-Missouri Freight Association*, 166 U.S. 290, 340 (1987)). *See also Offshore Logistics v. Tallentire*, 477 U.S. 207, 238 (1986). As noted by this Court in *Fiallo v. Bell*, 430 U.S. 787 (1977):

> With respect to . . . these legislative policy distinctions, it could be argued that the line should be drawn at a different point . . . but these are policy questions entrusted exclusively to the political branches of our government, and we have no judicial authority to substitute our political judgment for that of Congress.

430 U.S. at 798.

Both commentators and courts, including the Ninth Circuit, have embraced the view that because commercial paper, consumer debt, and trade groups were the focus of debate between 1978 and 1984 on whether to remove the 45-day rule,[7] a limitation on the ordinary cause exception should be inferred from the statute, notwithstanding the deletion of the 45-day rule in its entirety without qualification. In fact, a reading of the statute and review of the legislative history of the 1984 Amendments simply does not support such an interpretation.

In this case, although it is clear that Congress intended to leave normal financial relations undisturbed by enacting the ordinary cause exception, Congress has not determined which types of debt, *if any*, should be excluded from the exception if the debt was incurred in the debtor's normal financial relations. The 45-day rule, enacted as part of the ordinary course exception in the 1978 Bankruptcy Code, resulted in extensive litigation,[8]

[7] *Matter of CHG International, Inc.*, 897 F.2d at 1484; Broome, Lisa Lampkins, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments*, 1987 Duke L. J. 78, 100 (1987).

[8] *See, e.g.*, *In re Iowa Premium Service Co., Inc.*, 695 F.2d 1109 (8th Cir. 1982); *Barash v. Public Finance Corporation*, 658 F.2d 504 (7th Cir. 1981).

and various constituencies lodged complaints with Congress, requesting a change or deletion of the 45-day rule.

Trade groups argued that, although the 45-day limit apparently was chosen because it reflected the "normal billing cycle," it did not reflect the actual billing cycle for many industries.[9] In response to such concerns, Congress could have extended the 45-day period to 90, 100, or 120 days to encompass such industry business cycles, but it did not choose to do so.

Short term unsecured debt obligations, such as commercial paper, were also constrained by the 45-day rule. Maturities of commercial paper, which are typically of up to 270 days,[10] now were shortened to 45 days as a result of the rule. If Congress intended to except only trade and short term debt transactions from preference avoidance, it could have amended Section 547(c)(2) to extend the 45-day period to 270 days. However, Congress decided not to do so.

Various proposals were introduced in Congress prior to the 1984 Amendments to eliminate the problems caused by the 45-day rule, including (i) eliminating the 45-day rule altogether; (ii) reinserting the "reasonable

---

[9] *See* Broome, 1987 DUKE L. J. at 99 n. 100 (1987) (45 days selected as normal cycle); DeSimone, David J., *Section 547(c)(2) of the Bankruptcy Code; The Ordinary Course Without the 45-Day Rule*, 20 AKRON L. REV. 95, 111 (1986) (45 days not normal cycle in many industries).

[10] Broome, 1987 DUKE L. J. at 103 n. 116 (1987).

cause to believe" requirement included in the preference provision of the Bankruptcy Act; (iii) providing a separate exception for payments made on commercial paper or other short term obligations; and (iv) providing a separate exception for consumer installment debt.[11] Instead of enlarging the 45-day period or adopting an alternative proposal to protect specific types of debt, Congress simply enacted the 1984 Amendments providing for the deletion of the 45-day rule in its entirety. The legislative history of the 1984 Amendments provides *no* explanation of Congress' decision to delete the 45-day limitation on the ordinary course exception rather than adopt other proposals which sought to protect only certain types of debt.

Given that the legislative history does not contain an explicit statement of why Congress deleted the 45-day rule, it is inappropriate for the Court to decide that Congress intended a result that Congress expressly declined to enact. *Offshore Logistics, Inc. v. Tallentire*, 477 U.S. at 238 (Powell, J., dissenting), (quoting *Gulf Oil Corp v. Copp Paving Co.*, 419 U.S. 186, 200 (1974)). It is clear that the ordinary course exception, as presently enacted, without a distinction between "trade" and "non-trade" debt, or "short" and "long term" debt, is consistent with the original legislative policy underlying the ordinary course exception – to leave undisturbed the normal financial relations of the financially-distressed debtor.

---

[11] DeSimone, 20 AKRON L. REV. at 131 (1986).

B. Failure to Read the Plain Meaning of Section 547(c)(2) of the Bankruptcy Code Has Resulted in Inconsistent Judicial Interpretations.

In enacting Section 547 of the 1978 Bankruptcy Code, Congress, failed to define various statutory terms such as "ordinary course of business," "ordinary business terms," and when a debt is "incurred." Consequently, the courts have had to define these terms in interpreting and enforcing the preference provisions of the Bankruptcy Code. Substantial litigation has resulted concerning the meaning and scope of these terms. However, the 1984 Amendments did not further define any of these terms. In particular, it did not replace the 45-day rule with a limitation on the ordinary course exception to "trade debt" or "short term debt." Judicial deference to the legislature is appropriate, especially where Congress intentionally deleted the time limitation without substituting a new limitation on the *type* of obligation exempted from the ordinary course exception.

Unfortunately, many courts have not deferred to the plain meaning of the statute, nor have they deferred to Congress to modify the ordinary course exception if Congress believes such a change is necessary. Judicial decisions since the 1984 Amendments have read into the statute a limitation based on the nature of the debt and the terms for repayment.[12] In the case at bar, the Ninth

[12] *See, e.g., Fidelity Savings & Investment Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989); *In re Finn*, 909 F.2d 903 (6th Cir. 1990); *In re Control Electric, Inc.*, 91 B.R. 1010 (Bankr. N.D. Ga. 1988); *In re Bourgeois*, 58 B.R. 637 (Bankr. W.D. La. 1986).

Circuit did not define what constitutes short term debt, but held, without explanation, that a eight month bank line of credit does not qualify.[13]

Petitioner argues that, should this Court define long term debt, a one-year period is appropriate. Robert Morris Associates submits that, if some time period is to be specified, the Court should defer to Congress, which as the legislature is better suited to weigh various competing policy interests. A plain meaning interpretation of the statute will discourage the inconsistent judicial rulings that, in this case and others, result from courts attempting to legislate. Congress can address further limitations on the ordinary course exception by corrective amendments to the statute, should it determine further refinements are necessary.

CONCLUSION

Advocates of the plain meaning rule are often faulted for literalism, which may deny the true purpose of a statute. Literalism may be a fair criticism of an overly narrow reading of words inserted or left in a statute upon amendment. If the Court refuses to read in, or more accurately, refuses to read *back* into the statute words and meanings that Congress has *intentionally* deleted, the Court cannot be faulted for literalism. Robert Morris

[13] *In re ZZZZ Best Co., Inc.*, 921 F.2d 968, 969 (9th Cir. 1990), *cert. granted*, 59 U.S.L.W. 3769 (1991).

Associates submits that this Court should interpret Section 547(c)(2) according to its plain meaning, and reverse the decision of the Ninth Circuit.

Respectfully submitted,

Raymond K. Denworth, Jr.
Counsel of Record
Andrew C. Kassner
Sheila Oliver
Drinker Biddle & Reath
1100 Philadelphia National
Bank Building
Broad and Chestnut Streets
Philadelphia, Pennsylvania 19107

Attorneys for
Robert Morris Associates as
Amicus Curiae

No. 90-1491

In The

Supreme Court of the United States

October Term, 1991

UNION BANK,

Petitioner,

vs.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE AMERICAN COLLEGE OF REAL ESTATE LAWYERS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

Of Counsel:
JOHN S. HOLLYFIELD
President, American College of Real Estate Lawyers
RICHARD G. GOLDBERG
President Elect, American College of Real Estate Lawyers
WALTER J. TAGGART
Chairman, Bankruptcy Committee, American College of Real Estate Lawyers
RICHARD E. BARNSBACK
American Council of Life Insurance
BRUCE HYMAN
Member, American College of Real Estate Lawyers
ALAN ROBIN
Member, American College of Real Estate Lawyers
CHRISTOPHER F. GRAHAM
Thacher Proffitt & Wood
JILL H. ASHMAN
Thacher Proffitt & Wood
EUGENE YAMAMOTO
Landels, Ripley & Diamond

PHILLIP E. STANO
Counsel of Record
American Council of Life Insurance
1001 Pennsylvania Ave., N.W.
Washington, D.C. 20004-2599
(202) 624-2183

ROBERT M. ZINMAN
Counsel of Record
Chairman, Amicus Briefs Committee, American College of Real Estate Lawyers
St. John's University, School of Law
Jamaica, New York 11439
(718) 990-6646

Counsel for the Amici

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION ADDRESSED

The question addressed by the Amici Curiae is as follows:

> Does the ordinary course of business exception to the preference rules codified in 11 U.S.C. Section 547(c)(2) apply to scheduled payments on long term debt?

TABLE OF CONTENTS

TABLE OF CONTENTS – Continued

TABLE OF AUTHORITIES

INTEREST OF THE AMICI CURIAE

The American College of Real Estate Lawyers ("ACREL") is a nonprofit corporation, organized on April 28, 1980, for the purpose, *inter alia*, of gathering together lawyers "to improve and reform real estate law and practice." (ACREL Articles of Incorporation at 2.) ACREL's membership consists of approximately 750 attorneys from every state and the District of Columbia who have concentrated their practice in real estate law for a period of ten years or more, and law school professors specializing in the field of real estate law. In addition, members elected to ACREL must have demonstrated a willingness to devote time to improving real property law through writing, teaching or participation in professional association activities.

The American Council of Life Insurance ("Council") is a nonprofit voluntary trade association, the membership of which totals 616 legal reserve life insurance companies doing business throughout the United States. The member companies of the Council account for 93.6 percent of the legal reserve life insurance in force in this country and afford protection to approximately 154 million insureds.

Life insurance companies are among the nation's largest long term lenders. At the end of 1989, life insurance companies held $254.2 billion of long term debt secured by mortgages on American real property, which represented 19.5 percent of the total assets held by life insurance companies in that year.[1] The Council was

[1] American Council of Life Insurance, 1990 Life Insurance Fact Book 94 (ACLI, Washington, D.C. 1990).

directly involved in the events leading to the removal of the 45 day limitation from Section 547 of the Bankruptcy Code in 1984, and thus is particularly qualified to address the legislative intent issues regarding this statute raised by the Ninth Circuit.

This brief supports the position of the Petitioners in this case. Due to the Council's intimate participation in the legislative process and the background and lending experience of the *amici*, they are uniquely in a position to offer their expertise to this Court concerning the effect of the case below on long term lending. Additionally, the *amici* are competent to advise of the serious impact that the holding below, if not reversed, could have on real estate mortgagees, the willingness and ability of institutions to continue to make long term loans, and the life insurance and real estate industries.

SUMMARY OF ARGUMENT

Section 547 of Title 11 of the United States Code (the "Bankruptcy Code") subjects to attack and avoidance as preferential transfers, certain payments to creditors made within specified periods prior to a filing for protection under the Bankruptcy Code.[2] Section 547(c)(2) of the Bankruptcy Code (the "Ordinary Course Exception") excepts from such avoidance, certain payments of debt that are made in the ordinary course of business of the transferor and transferee. The Ninth Circuit incorrectly concludes in the decision below that, as a matter of law,

[2] 11 U.S.C. § 547 (1979 & Supp. 1991).

payments on long term debt do not fall within the Ordinary Course Exception. Your *amici* respectfully submit that no such exclusion of long term debt exists.

In 1984, Congress deleted the original limitation of the Ordinary Course Exception which restricted the applicability of the exception to transfers made within 45 days following the incurrence of a debt. The plain language of the Ordinary Course Exception as amended is clear and unambiguous – it applies to all debt that meets the ordinary course standards of the exception.

Where as here, the language of the statute is plain and unambiguous, reference to legislative history is unnecessary. Even if the legislative history of the 1984 Amendment to section 547(c)(2) is consulted, it will provide little insight into this issue, as long term debt is not specifically addressed. Your *amici* submit that evidence exists that Congress considered and understood that the removal of the 45 day limitation on the Ordinary Course Exception would allow the exception to apply to long term debt. Contrary to the Ninth Circuit's premise, long term lenders, including the Council, actively participated in the development of the 1984 Amendment to Section 547(c)(2).

The Ninth Circuit's unilateral exclusion of long term debt from the protection of the Ordinary Course Exception will place long term lenders at a severe disadvantage in the following instances, which will result in further tightening of credit markets and increased interest rates:

a. Lenders and purchasers of mortgaged backed securities, who have relied on the plain language of the

Ordinary Course Exception in making or purchasing interests secured by long term loans, will find that ordinary course payments under these loans may be recovered in the bankruptcy case of a borrower.

b. Read together with the Seventh Circuit's decision in *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989) (hereinafter referred to as the "*Deprizio*" case), the Ninth Circuit's decision in ZZZZ *Best* could make principal and interest payments made within one full year prior to bankruptcy subject to avoidance as preferences whenever the mortgage is only partially secured and the loan is guaranteed by an insider.

c. The Ninth Circuit's decision allows a debtor to abuse the bankruptcy laws by forestalling a lender's remedies to protect its security.

The exclusion of all long term lenders from the protection of Section 547(c)(2) is unnecessary to protect the integrity of the statute since the ordinary course of business requirement provides an ample statutory basis for courts to police the propriety of claims asserted under this exception.

ARGUMENT

I. THE PLAIN MEANING OF THE ORDINARY COURSE EXCEPTION AND ITS LEGISLATIVE HISTORY MANDATE INCLUSION OF LONG TERM DEBT WITHIN THE CLASS OF PROTECTED PAYMENTS.

A. The plain meaning of Section 547(c)(2) affords protection from preference attacks to scheduled payments on long term debt.

The Ordinary Course Exception explicitly excepts from preference avoidance transfers to creditors:

> (A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and transferee; and
>
> (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2).

A fundamental issue in this case is whether the Ordinary Course Exception applies to scheduled repayments of long term debt. Traditional tenets of statutory construction require that this Court first look to the plain meaning of the statute to resolve any questions as to its application. *Toibb v. Radloff*, 59 U.S.L.W. 4633 (U.S. June 13, 1991) ("where, as here, the resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear.").[3]

The plain meaning of the Ordinary Course Exception is that all payments that constitute ordinary course of business transfers pursuant to that section's three prong

---

[3] *Toibb*, 59 U.S.L.W. at 4634 (quoting *Blum v. Stenson*, 465 U.S. 886, 896 (1984)), involved the interpretation of Section 109 of the Bankruptcy Code. In holding that this section allowed individuals who were not engaged in business to file for relief under chapter 11, this Court noted that the plain language of Section 109 did not limit the protections of chapter 11 to business entities. This Court reached its decision despite the fact that "the structure and legislative history of chapter 11 indicate that [the] provision was intended primarily for the use of business debtors." *Toibb*, 59 U.S.L.W. at 4635.

test are excepted from preference avoidance. Section 547(c)(2) does not distinguish between short term and long term debt. Rather, the standard used for determining whether a payment is protected by the exception is whether the debt, its terms, and the payment are the kind found in the debtor's and creditor's ordinary course of business. Certainly, traditional long term real estate development loans and corporate bond indentures are examples of transactions which fall within the ordinary course of business of many debtors.

The Sixth Circuit adopted the foregoing analysis in its holding in *Gosch v. Burns (In re Finn)*, 909 F.2d 903 (6th Cir. 1990). In that case, the Sixth Circuit determined that since Congress had not limited the language of section 547(c)(2) to cover only particular transactions, no such limitation could be assumed or implied.

Thus, the plain language of the Ordinary Course Exception applies to all payments of long term debt.

B. The legislative history of the 1984 Amendment to Section 547(c)(2) does not support the exclusion of long term debt.

Even assuming *arguendo*, that some colorable argument could be fashioned that the language of the Ordinary Course Exception is ambiguous, the Ninth Circuit's premise regarding the legislative intent of revised Section 547(c)(2) is incorrect.[4]

[4] The Ninth Circuit's decision in ZZZZ *Best* that long term debt is excluded from the protection of the Ordinary Course

(Continued on following page)

Rather than acknowledge the absence of pertinent legislative history to the 1984 Amendment indicating that Congress intended to exclude long term lenders from the protection of the Ordinary Course Exception, the Ninth Circuit simply made the assumption that Congress intended the Ordinary Course Exception to apply only to short term or trade debt. The court reaches this conclusion because the statute, as originally enacted, contained a restriction that allowed protection only to those payments made within 45 days of the date on which the debt was incurred. Although the 1984 Amendment to Section 547(c)(2) deleted this 45 day restriction, the Ninth Circuit ignores the Amendment and assumes that the type of debt originally protected by the statute remains the only debt so protected.

Without pertinent legislative history to show that long term debt was intended to be excluded from section 547(c)(2),[5] the Ninth Circuit created the presumption that

(Continued from previous page)

Exception is founded solely on its previous analysis of this issue in *CHG Int'l., Inc. v. Barclays Bank*, 897 F.2d 1479 (9th Cir., 1990) (hereinafter referred to as the "*CHG*" decision). References to the Ninth Circuit's reasoning are, therefore, to the *CHG* decision.

[5] The only legislative history cited by the Ninth Circuit in the *CHG* decision related to S. 445, which was passed by the Senate a year earlier in the ninety-eighth Congress. Section 221(b) of S.445 eliminated the 45 day requirement of Section 547(c)(2). The Senate Report, which was cited by the Ninth Circuit, observed that the 45 day requirement had placed "undue burdens upon creditors . . . [with] billing cycles greater than 45 days." *CHG*, 897 F.2d at 1484 n.6 (citing S. Rep.

(Continued on following page)

Congress did not intend to include long term loans under the Ordinary Course Exception. Once this judicially created presumption was in place, the Ninth Circuit required a showing of affirmative legislative history to prove that long term lending was to be included within the protection of Section 547(c)(2). In effect, the Ninth Circuit imposed on Congress the obligation to prove that it meant what it said in the text of the statute by writing a report or engaging in floor debate. This is hardly the proper use of the plain meaning rule of statutory construction.[6]

(Continued from previous page)

No. 98-65, 98th Cong., 1st Sess. 60 (1983)). While this comment would seem to refer to trade debt and trade debt was certainly a major consideration of the drafters, it does not in any way limit the applicability of Section 547(c)(2) to such debt. Indeed on the Senate floor, Senator DeConcini indicated that the change included commercial paper, 130 Cong. Rec. S8897 (daily ed. June 29, 1984), and commentators are in general agreement that the Ordinary Course Exception includes short term debt, which is not necessarily trade debt. Moreover, if all the amendments to Section 547 that were contained in S. 445 are considered, it is clear that the Senate was not concerned solely with trade debt, but rather intended to address a range of issues including long term debt. See S. Rep. No. 98-65, 98th Cong. 1st Sess. 60 (1983) (explaining Section 221(a) of S. 445).

[6] There is ample indication of Congressional intent with respect to the scope of the preference provisions of the Bankruptcy Code, all of which is consistent with the application of Section 547(c)(2) to any debt meeting the ordinary course requirements, whether the debt be long or short term. The original legislative history that accompanied this section of the Bankruptcy Code stated that it was designed "to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage

(Continued on following page)

II. THE NINTH CIRCUIT MISCONSTRUES THE INTENTION OF CONGRESS WITH REGARD TO THE REMOVAL OF THE 45 DAY LIMITATION FROM SECTION 547(c)(2).

A. Contrary to the Ninth Circuit's conclusion, long term lenders participated actively in the development of the 1984 amendment to Section 547(c)(2).

The Ninth Circuit based its holding in *CHG* and the decision below on an unsupported assumption that Congress did not intend to "fundamentally change the scope of the ordinary course exception by including more than transactions which are substantially contemporaneous exchanges."[7] 897 F.2d at 1483.

To support its contention that Congress did not intend to deal with other than short term debt in the 1984 Amendment, the Ninth Circuit stated that trade creditors sought relief from Congress from the strict constraints of

---

(Continued from previous page)

unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." H.R. Rep. No. 595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6329. The eventual elimination of the 45 day limitation and the opening up of the Ordinary Course Exception to all loans does not conflict in any way with this basic objective. Indeed, amended Section 547(c)(2) appears to accomplish Congressional goals where the earlier version did not.

[7] The Ninth Circuit appears to confuse the Ordinary Course Exception with substantially contemporaneous exchanges which were and continue to be excepted from preference avoidance under Section 547(c)(1).

a 45 day limitation, but that "long term lenders had not been active in seeking this change." 897 F.2d at 1484. Quite to the contrary, your *amicus*, the Council, through its Legislative Committee and Subcommittee on Federal Bankruptcy Legislation, actively participated on behalf of the life insurance industry, the archetypal long term lenders, in the discussions leading to this change.

During the period that the 1984 Amendment to Section 547(c)(2) was under consideration, the insurance industry expressed its concern about several aspects of long term lending that were adversely affected by the preference provisions. First was the common practice of insurance companies and other long term lenders to require a letter of credit as additional security for certain loans where lenders funded loans on partially completed improvements or on completed improvements that had not been fully leased. Second was the impact on loans in which an entity related to the borrower agreed to maintain a minimum net worth or minimum working capital of the borrower until certain financial conditions were met. Third was the enforceability of indemnity bonds such as completion and payment bonds obtained from a surety company in connection with a loan.

When the lender received regular payments of principal and interest on these long term loans, each of these third parties – the issuer of the letter of credit, the related entity agreeing to maintain a minimum net worth of the borrower, and the surety – was often relieved of its obligation to the lender. If the payments made by the borrower were later held to be voidable preferences, the lender would no longer have recourse against the third party on its undertaking.

In light of these concerns, the Council sought specific relief from preference attacks in these situations. The Council communicated this request to Congress along with several other suggestions for amendments to the Bankruptcy Code. On November 11, 1981 the Council wrote to Senator Robert J. Dole, then Chairman of the Subcommittee on Courts of the Committee on the Judiciary – the Committee responsible for the development of the 1984 Bankruptcy Code Amendments in the Senate. (A copy of this letter is appended hereto as Exhibit A.)

The letter in paragraph 5(a) contained a proposal for a new subsection (7) to 547(c) that would except transfers:

> to or for the benefit of a creditor to the extent such transfer was made to such creditor in payment of a debt evidenced by a note issued by the debtor and payment of which was supported from time of its issuance until such transfer by an irrevocable letter of credit, commitment to lend funds or bonds of indemnity issued by a bank or by an insurance company. (Appendix A, at App. 11).

The Council's proposal was similar to a bill, S.3023, introduced by Senator DeConcini a year earlier. Importantly, Senator DeConcini's earlier version of subsection (c)(7) included a requirement that the debt be incurred within nine months of the transfer. In referring to the original proposal by Senator DeConcini, the Council made the following statement in its letter to Senator Dole:

> The Council favored this provision but did not understand the reason it was limited to loans with a maturity of nine months or less. . . . We suggest the addition of the following language which tracks the language in S.3023 except that the limitation to loans with maturities of nine

months or less has been deleted. . . . (Appendix A, at App. 11).

The need for a new subsection (c)(7) was later rendered moot when congressional staff orally explained to the Council that they planned to propose the deletion of the 45 day limitation from Section 547(c)(2) to avoid the preference problem for ordinary course payments of principal and interest on long term loans. The deletion of the 45 day restriction resolved the Council's concern. Therefore, the Ninth Circuit's assumption that long term lenders played no role with respect to the long term lending issues involved in the Ordinary Course Exception is simply unfounded and inaccurate.

B. Congress, aware of the concerns of long term lenders, understood that the removal of the 45 day limitation from the Ordinary Course Exception permitted that section to apply to long term debt.

That Congress adverted to the contents of the letter from the Council is indicated by the incorporation into the Bankruptcy Code of several of the suggestions made in that letter[8] and by a letter acknowledging the efforts of the Council from Senator Dole. (A copy of this letter is appended hereto as Exhibit B). Given this involvement by long term lenders in the development of the 1984 Amendment to Section 547(c)(2), it seems inconceivable that a credible argument can be made that Congress did not know that the removal of the 45 day limitation from Section 547(c)(2) would save from preference attack regular payments of principal and interest on long term debt.

[8] For example, the letter suggested an amendment to protect a leasehold mortgagee or subtenant when the landlord in bankruptcy disaffirms the lease and the non-debtor tenant elects to treat the lease as terminated; this suggestion was included in the revised section 365(h). The Council also suggested that the Bankruptcy Code should include anti-*Durrett* (*Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir.

(Continued on following page)

III. THE NINTH CIRCUIT'S EXCLUSION OF LONG TERM LENDERS FROM THE PROTECTION OF THE ORDINARY COURSE EXCEPTION PUTS SUCH LENDERS AT A SEVERE DISADVANTAGE AND MAKES FINANCING MORE DIFFICULT FOR PERSONS WITH LESS THAN THE HIGHEST CREDIT RATING.

A. Lenders have justifiably relied on the protection of Section 547(c)(2) in extending credit.

Relying on the clear and unambiguous language of the Ordinary Course Exception, long term lenders have extended credit to borrowers based on underwriting that presumed that payments of debt service in the ordinary course of business would not be subject to preference avoidance. The Seventh Circuit's decision in the *Deprizio* case provided added assurance to long term lenders. There, the Seventh Circuit explained the meaning of the Ordinary Course Exception and used scheduled

(Continued from previous page)

1980)) language; this language was included in the Senate Bill but deleted at the request of Senator Metzenbaum shortly before the floor vote.

payments of long term debt as a prime example of transfers covered by that exception.[9]

Long term lenders do not expect that all payments under long term loans are subject to the Ordinary Course Exception. They realize that non-scheduled payments of interest or principal would be subject to avoidance because such payments are not made in the "ordinary course of business or financial affairs of the debtor."

The lenders' view that ordinary course transactions would be left undisturbed by the preference section is consistent with the legislative history of the original version of section 547(c)(2)[10], and with the clear and unambiguous language of the revised Ordinary Course Exception.

[9] The court used the following example to illustrate the protection afforded ordinary course payments on long term debt:

> A creditor makes an unsecured loan guaranteed by an insider and requires monthly payments over a number of years. The trustee seeks to recover all of the payments during the year before the filing. To the extent the debtor paid on time, the creditor is protected by the current version of § 547(c)(2), the "ordinary course" rule.

Deprizio, 874 F.2d at 1200.

[10] *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S. Code Cong. & Admin. News at 6329.

B. Read with *Deprizio*, the Ninth Circuit's decision in *ZZZZ Best* will result in subjecting all payments of principal and interest on undersecured debt in the full year prior to bankruptcy to preference attack where the loan is guaranteed by an insider.

In *Deprizio*, the Seventh Circuit held that instead of the normal 90 day reachback period for preferences, a one-year reachback period is applicable in cases where loans are guaranteed by insiders. While the direct transferee in *Deprizio* was not an insider, the court reasoned that the payment was for the benefit of an insider because the payment freed the insider of liability on the guarantee and the insider was a creditor of the debtor by virtue of subrogation rights. As discussed above, the Seventh Circuit assured long term lenders that they were protected from preference attack on ordinary course debt service payments.

If the Ninth Circuit's interpretation of the Ordinary Course Exception were to be upheld and read in conjunction with *Deprizio*, all payments of interest and principal on undersecured loans in the year prior to a filing for bankruptcy could be subject to preference attack if the loan were guaranteed by an insider.

A guarantee by an insider is often the catalyst that permits financing transactions to go forward when the financial condition of a borrower would normally preclude the extension of credit. If payments made in the ordinary course of business during the year prior to bankruptcy can be withdrawn from lenders by the courts, lenders will restrict extensions of credit and only make loans to those who have demonstrated substantial financial stability – the credit crunch for start-up companies and other borrowers will become even tighter.

C. The Ninth Circuit's denial of the protection of Section 547(c)(2) to long term lenders encourages debtors to manipulate the bankruptcy laws to disadvantage such lenders unfairly.

Insurance companies, pension funds, commercial banks, and savings and loans regularly make loans for the development and acquisition of real estate. These loans are usually secured by mortgages on real estate and, if appropriate, security interests in rents received for use of real estate.

Often when a mortgage loan is in default, the value of the real estate that secures the mortgage debt is less than the amount due the mortgagee.[11] Regular debt payments to any partially secured real estate lender may be subject to preference attack under the Ninth Circuit's decision, because the lender will receive more as a result of receipt of debt payment than it would have received in a Chapter 7 case.

Knowing that the regular payments of principal and interest within the applicable preference period may be recovered and used to keep the business alive during the reorganization process, the borrower is encouraged to continue to make installment payments as they become due. By making the payments, the borrower is able to prevent the lender from discovering the borrower's

[11] If the value of the mortgaged real estate is and remains greater than the amount due to the mortgagee, prepetition payments of principal and interest on the debt do not constitute preferential transfers because in a Chapter 7 case the mortgagee would be fully satisfied by the proceeds from the sale of the real estate. 11 U.S.C. § 547(b)(5).

financial problems and from exercising default remedies set forth in the note and mortgage, thus forestalling foreclosure and in some cases, impeding the perfection of the lender's security interest in rents. When bankruptcy ensues, the borrower as debtor in possession may simply file a preference action and recover the installment payments made to a long term lender. The recovered payments will be available to fund Chapter 11 expenses. This manipulation confers an unfair benefit to the borrower at the expense and detriment of the lender.[12]

In those jurisdictions where it is necessary to take some affirmative act, such as obtaining the appointment of a receiver, to perfect the lender's security interest in rents, the borrower's free-ride strategy will either eliminate the mortgagee's lien on postpetition rents[13] or, at the very least, delay the mortgagee in obtaining recognition of the lien until some time after the petition is filed.[14] A

[12] In theory, any preferential payments that are recovered during a reorganization will benefit the creditors of the estate. In practice, however, a debtor will use the recovered preferential payments to pay current reorganization expenses.

[13] Although section 552(b) of the Code preserves the mortgagee's lien on rents, the lien must be perfected under state law, which in some instances requires an affirmative act by the mortgagee prior to the filing of a case under the Bankruptcy Code. *See In re Wynnewood House Associates*, 121 Bankr. 716 (Bankr. E.D.Pa. 1990). Thus, unless an installment payment is missed, the mortgagee will not be able to gain control of the rents, except in the rare instance where the mortgagee knows of some other material default by the owner-mortgagor.

[14] On various theories, courts have permitted perfection post-petition. For example, one line of cases has held that the post-petition filing of a motion for sequestration of rents in the

(Continued on following page)

mortgagor should not be able to use the bankruptcy laws to play this no-lose game.

CONCLUSION

The decision of the Ninth Circuit should be reversed.

Respectfully submitted,

PHILLIP E. STANO
Counsel of Record
American Council of
Life Insurance
1001 Pennsylvania Ave.,
N.W
Washington, D.C. 20004-2599
(202) 624-2183

ROBERT M. ZINMAN
Counsel of Record
Chairman, Amicus Briefs
Committee, American
College of
Real Estate Lawyers
St. John's University,
School of Law
Jamaica, New York 11439
(718) 990-6646

(Continued from previous page)

bankruptcy court is a proper method for perfecting the mortgagee's lien on rents. *See Virginia Beach Federal Savings & Loan Ass'n v. Wood*, 901 F.2d 849 (10th Cir. 1990).

APPENDIX A

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006
(202) 862-4000

November 11, 1981

The Honorable Robert J. Dole
Chairman, Subcommittee on Courts
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Senator Dole:

I am Chairman of the Subcommittee on Federal Bankruptcy Legislation of the American Council of Life Insurance. The Council has a membership of 525 life insurance companies which in the aggregate have 95% of the life insurance in force in the United States and hold 97% of the assets of all life insurers.

At the end of 1980, total assets of the life insurance companies aggregated more than $475 billion, invested mainly in corporate and government securities and mortgage loans to businesses and individuals. These funds represent the amounts that have been entrusted to our business by millions of individual policyholders and employee benefit plans. As part of its role in protecting these investments, the Council through the Subcommittee has monitored and supported changes in the bankruptcy laws which would improve the effective administration of the bankruptcy laws of the nation.

The Council appreciates this opportunity to comment on the provisions of S.863, which would amend the Bankruptcy Code. In reviewing the bill, we noted the following areas which are of concern to the industry or in

connection with which clarifying or technical changes would be appropriate.

1. Section 548 – Fraudulent Transfers.

Durrett v. Washington National Insurance Co., 621 F. 2d 201 (5th Cir., 1980), held that a nonjudicial foreclosure sale was a transfer within the meaning of the former Bankruptcy Act and subject to being set aside as fraudulent if it were made without fair consideration within one year prior to the filing of the bankruptcy petition. This decision would seem equally applicable to cases under section 548 of the Bankruptcy Code. In *Durrett* it was agreed that the purchaser at the foreclosure sale was an innocent third party who saw the advertised sale in the paper, attended the sale and bid the amount of the mortgage indebtedness. The *Durrett* case was recently followed in the case of *Abramson v. Lakewood Bank & Trust Co.*, 647 F. 2d 547, (5th Cir. 1981), and in *In re Madrid*, 10 BR 795 (D.Nev., 1981). In those cases, the argument was made that since the definition of transfer includes involuntary transfers as well as voluntary transfers, a foreclosure sale would be a transfer within the meaning of the fraudulent transactions provisions. Such reasoning could apply whether the sale is a judicial or nonjudicial sale.

Unless something is done to overrule the effect of *Durrett* and the cases following it, a serious dislocation will result in the mortgage market which is already suffering from tight money, disintermediation and inflation. Certainly lenders will hesitate to lend substantial sums of money in reliance on security upon which they may not be able to realize when a default occurs. Even worse, lenders are concerned that

under section 550(a)(2) they may be called upon to pay to the debtor the difference between the amount of the mortgage and what the bankruptcy court thinks the value of the property is.

Surely, the whole concept of a foreclosure sale is designed to obtain the most money possible on foreclosure. Of course, a foreclosure is a distress sale and is likely not to bring the same amount as a sale under normal market conditions. But, if there is substantial value in excess of the mortgage balance, an owner-debtor can normally raise the mortgage balance through substitute financing or third party bidding will raise the price toward such value. If a court can later determine that the sale price is not reasonably equivalent value and apply the fraudulent transactions provisions, the certainty necessary to successful mortgage financing would be lost.

What also concerns the lender is that even where it is clear to the lender that the property is worth no more than the amount of the mortgage, the mortgagee may be required to bid the property in at the full mortgage balance notwithstanding substantial transfer taxes that would be occasioned by such bid. Furthermore, having acquired the property, the mortgagee would not be in a position to rehabilitate it or sell it for a period of at least a year out of fear that the borrower may file in bankruptcy and the bankruptcy court during that period of time may find the foreclosure to have been "fraudulent".

To extend the fraudulent transactions provisions to mortgage loans often made years before bankruptcy not only makes no sense but will harm the economy and stifle mortgage investments at a time when they should be encouraged. In fact, it hurts the very owner-debtor it purports to protect. Competitive bidding will be

inhibited and third party bids will tend to be lower because of the risk that the transaction may later be declared void by a bankruptcy court, thus reducing the possibility of bids in excess of the mortgage balance (funds which would go to the owner-debtor) and increasing the likelihood of deficiency judgments.

It is therefore strongly urged that the Code be clarified in S.863 to restore the validity of foreclosure sales. This can be accomplished by amending the definition of "transfer" in section 101(40) of the Code to add in the end thereof, the following sentence:

> "For the purposes of section 548 of this title, the transfer of property as security for a loan under a mortgage, deed of trust, or other security agreement is deemed to take place at the time the mortgage, deed of trust or security interest is perfected and not at the time title is placed in the name of the secured party or third party purchaser pursuant to foreclosure, power of sale or other provisions of law permitting or providing for realization of the security upon the default of the borrower."

2. Landlord's Bankruptcy – Section 365(h).

a. Termination by Nonbankrupt Tenant. For some time we have been concerned about section 365(h) which, while designed to give a nonbankrupt tenant the right to remain in possession notwithstanding disaffirmance by the landlord's trustee, also gives the tenant the alternative of treating the lease as terminated. The effect of an election to terminate on leasehold mortgagees and sublessees is unclear. It was the Council's understanding at the time we participated in formation of the Bankruptcy Code that the language giving the tenant the

right to treat the lease as terminated was merely designed to restate nonbankruptcy law (that where the breach by the landlord is sufficient to give the tenant the right to terminate, such right would be preserved). The real estate industry, however, was concerned that the right as stated in section 365(h) could be construed as a special bankruptcy right to terminate that would override provisions of nonbankruptcy law or agreements the tenant might have with leasehold mortgagees or sublessees. Of course, the bankruptcy law would have no reason to give a nonbankrupt tenant the right to abrogate its agreements with third parties. However, in response to these concerns, the Council urged that the language giving the trustee the right to terminate be deleted from the statutory language and suggested legislative history to make it clear that no substantive change was intended by such deletion.

The drafters of S.863 dealt with the problem in a different way. Section 27(i) of S.863 adds a new subsection (3) providing that a subtenant or leasehold mortgagee could succeed to the right of the tenant to remain in possession if the tenant chose to treat the lease as terminated. It was the Council's view that this language was ambiguous because it did not deal with the question of how the succession to the rights of the tenant would be implemented. We were gratified to see the language in the Senate Report 97-150 (page 7) which helps to clarify this ambiguity. Since it is possible that the courts will not adhere to the interpretation in the legislative history, we still prefer the alternative approach of eliminating the language which could be construed as creating a special bankruptcy right on the part of the nonbankrupt tenant to terminate the lease.

Our recommendation was that in lieu of the proposed amendment we delete the words "may treat the lease as terminated by such rejection, or in the alternative," from the language of section 365(h)(1). The deleted language was not found in prior bankruptcy law where the non-bankrupt tenant's rights to terminate its lease were determined by nonbankruptcy law. As far as we are aware, the absence of such language did not create any problem.* To avoid any misunderstanding as to what the deletion was intended to do, we suggest that legislative history be inserted to the effect that such deletion is not intended to change the law, in language such as:

> "The words 'may treat the lease as terminated by such rejection, or, in the alternative', were deleted from §365(h)(1) in order to avoid an interpretation that a lessee, who is not the debtor, was afforded a special right to terminate its lease on disaffirmance by the debtor-lessor. A lessee, upon failure of the lessor's trustee on disaffirmance to perform lessor's obligations, should have the same rights as the lessee would have upon failure of the lessor to perform its

* Professor James Angell MacLachlan (who drafted the disaffirmance provisions of the Chandler Act) discussed the non-bankrupt tenant's rights on disaffirmance by the landlord in a letter to me of April 15, 1961 (26 *Bus. Law.* 1391, 1438-40 (1971)). He said: "There is nothing to stop the lessee from moving out on general contract principles, if the landlord [by disaffirmance] makes any breach going to the essence of the contract and I would suppose the inability of the lessor to respond in damages would tend to advance the point at which a breach would go to the essence of the contract. . . . [The tenant] certainly ought not to be compelled to continue performance notwithstanding the breach of important covenants."

> obligations under nonbankruptcy law. Section 365(g) states that a disaffirmance constitutes a breach of the lease. However, such breach should not of itself be the basis for termination of the lease by the lessee. The lessee should be able to terminate the lease only where the failure of the trustee to perform as the result of disaffirmance amounts to such a breach as would entitle the lessee to treat the lease as terminated by virtue of the terms of its lease, other nonbankruptcy law or other agreements the lessee has made with leasehold mortgagees, sub-lessees or other parties."

We think this would preserve the intent of section 365(h) to protect the tenants by enabling the tenant to remain in possession upon disaffirmance by its landlord while avoiding the ambiguity in the language of the current draft.

b. Meaning of "Possession". In addition to the termination problem in section 365(h), we were concerned about some recent testimony before the Subcommittee on Courts, U.S. Senate Committee on the Judiciary, which indicated that the protection of section 365(h) might apply only where the lessee is physically "in possession." If the word "possession" were interpreted so technically, doubts would be created about the efficacy of the protection granted by section 365(h) when property is subleased. Even if possession by a sublessee were considered possession by the lessee, it would not be clear whether a trustee for a landlord would be able to terminate if the sublessee had moved out or been evicted, or if, in connection with a "ground" lease of an entire office building, some space had become vacant.

We believe the testimony was intended to mean that the tenant had to have possession in the

sense of possession of the tenant's estate, in other words, that the lease had to have commenced at the time of disaffirmance. However, the word "possession" in the statute is troublesome for both tenants and leasehold mortgagees, and we recommend a further clarification to correct this problem. Our suggestion is that the words "in possession" be deleted from (h)(1) and (h)(2) and in its place the words "as lessee under a lease the term of which has commenced" be inserted. This would clear up the ambiguity without changing the intention of the section. In lieu of the foregoing, legislative history might be inserted to clarify this question, but a more desirable approach would be through the statutory change suggested.

3. Section 365(i) – Vendor's Bankruptcy.

While the new section 365(h)(3) proposed in S.863 would deal with the problem of the tenant's right to terminate on landlord's disaffirmance, there is no similar change in section 365(i) relating to the effect of disaffirmance of a contract of sale of real estate by a vendor. Like 365(h), section 365(i) provides that the vendee who is in possession (and here we believe physical possession is what was intended) may remain in possession, make his contracted for payments and receive a deed when the payments are made, or in the alternative, treat the contract as terminated.

As with section 365(h), we do not believe there was any intention to grant a special bankruptcy right in the nonbankrupt vendee to terminate the contract of sale unless the breach occasioned by the disaffirmance was such as to permit such termination under nonbankruptcy law or the terms of the contract of sale. However, the present language of the section will seriously limit the ability of the purchaser under a long-term

land sale contract to obtain financing secured by its growing equity under the contract. Therefore, as with section 365(h) it is urged that the right to treat the contract as terminated be deleted, or, in the alternative, that language similar to what is contained in S.863 with respect to section 365(h) be inserted as follows:

> "Section 365(i) of the United States Code is amended by addition of the following new subsection:
>
> '(3) In the event that the purchaser shall elect to treat such contract under this subsection as terminated, any holder of a security interest in such purchaser's interest may elect to succeed to the right of such purchaser to remain in possession.' "

4. Section 365(b)(2)(A) – Assumption of Leases by a Tenant's Trustee.

At the time of drafting of the Bankruptcy Code, the Council took a position in opposition to the absolute prohibition on termination of leases by a landlord on the tenant's bankruptcy and the consequent right of the trustee to assume or assign such leases. Instead, the Council had urged exceptions which would permit termination by a landlord where the lease was entered into before the effective date of the Code, where the property subject to the lease was not essential to a reorganization, or where the lease had a low base rent, with additional rent contingent on profits or sales. Especially in the latter situation, the Council felt public policy would dictate encouraging such leases rather than discouraging them. While the Senante [sic] bill incorporated exceptions similar to those suggested by the Council, these exceptions were not included in the bill as finally enacted. Thus the Bankruptcy Code Contains a general prohibition on

the landlord's right to terminate (with specific exceptions not relevant here) and grants a right to the trustee to assume the lease provided he cures defaults (other than defaults based on the financial condition of the debtor), compensates the party affected by the default and provides adequate assurance of future performance.

Under section 27(a) of S.863, the right of the trustee to assume has been expanded to eliminate the required curing of a default if the default were based on the financial condition of an "insider" of the debtor. Since many leases are entered into based upon the credit of a guarantor (who may often fit within the definition of "insider"), this provision will substantially expand the ability of the trustee to assume, and our members have expressed concern about this expansion. The Committee report states that the amendment "makes a technical change". It is our feeling that it goes much further than that and makes a substantive change in the rights of the lessor. Therefore, it is urged that this addition be deleted.

5. Section 547 – Preferential Transfers.

a. Letter of Credit Problem. The Council is concerned about the effect of section 547 as it applies to credit extended relying upon a letter of credit from the bank or insurance company. When the payment of this debt is made (normally after the 45-day "safe harbor" provided in section 547(c)(2)) the obligations of the issuer of the letter of credit end. If a bankruptcy trustee later sets aside such payments as unlawful preferences, the creditor no longer has recourse to the bank or insurance company issuing the letter of credit. To avoid this inequitable result and to encourage lenders to continue to make these

types of loans which are so important in commercial financing, Senator DeConcini introduced S.3023 on August 5, 1980, which would have added a new subsection (7) to section 547(c) to provide that the trustee might not avoid a transfer in this situation if the note did not have a maturity in excess of nine months. The Council favored this provision but did not understand the reason it was limited to loans with a maturity of nine months or less. S.3023 was never enacted into law and it has not been included in S.863.

The Council urges that protection be afforded to the lender in this situation. We suggest the addition of the following language which tracks the language in S.3023 except that the limitation to loans with maturities of nine months or less has been deleted:

> "(7) to or for the benefit of a creditor to the extent such transfer was made to such creditor in payment of a debt evidenced by a note issued by the debtor and payment of which was supported from time of its issuance until such transfer by an irrevocable letter of credit, commitment to lend funds or bonds of indemnity issued by a bank or by an insurance company."

We have reviewed a draft of proposed legislation designed to deal with many problems under the preference provisions and especially support the restoration of the requirement that the transfer may not be avoided unless the creditor receiving the transfer had reasonable cause to believe the debtor was insolvent. Since in the letter of credit situation, discussed above, the creditor will often be unaware of the debtor's insolvency, this change in section 547 would go a long way toward alleviating the inequities we discussed. However, this will not completely

solve the problem, and since the restoration of the reasonable cause to believe requirement is not certain, the Council urges the inclusion of the language set forth above.

b. Twist Cap Problem. The foregoing discussion deals with a situation where a debtor has made its payments in the ordinary course of business and such payments are later considered to be unlawful preference. In the *Twist Cap* case, (*Twist Cap v. Southeast Bank of Tampa*, 1 BR 284 (D.Fla., 1979)) the situation was somewhat different. There, the debtor whose obligation had been guaranteed had not made his payments when he filed a petition in bankruptcy. The creditor looked to the guarantor of the obligation. Before making the guaranty, the guarantor had obtained an agreement giving the guarantor a lien on the debtor's property to cover payments under the guaranty. The court stayed the payment by the guarantor to the creditor on the ground that such payment would activate a lien on the debtor's property and, the court believed, would amount to an unlawful preference. An amendment to restore the requirement that the creditor have reason to believe the debtor is insolvent would not solve the problem in this situation inasmuch as the debtor is already in bankruptcy at the time the creditor looks to the guarantor for payment.

To correct this situation we suggest that an amendment be made to section 362(b) by adding a new subsection (6) and renumbering subsections (b)(6) and (b)(7) as (b)(7) and (b)(8). The new subsection would provide that the filing of a petition would not operate as a stay:

> "(6) under subsection (a) of this section, of any act to collect, assess or recover against a guarantor of the debtor, a claim against the debtor that arose before the commencement of the case under this title;".

6. Section 1111 – Secured Creditor's Election.

Section 99 of S.863 amends section 1111(b) to provide, *inter alia*, that the subsection would apply "except where property of the estate that secures a claim is sold subject to section 363(k) of this title." While the Code presently has a similar exception, that exception would not seem to apply to an election under subsection (b)(2) for a full secured claim by a nonrecourse creditor. We are not certain why the exception was broadened.

Under the exception as it is currently worded, a nonrecourse secured party cannot convert its claim to a recourse claim where property is sold under section 363(k). The fear that this might be misinterpreted to limit the amount the nonrecourse secured party may offset against its bid on such a sale to a lower section 506 value given to the collateral is mitigated by the seeming ability of the nonrecourse secured party to protect itself from such a result by electing the full claim under section 1111(b)(2). The proposed amendment would prevent such an election and may result in consequences which would be highly inequitable.

If the secured party, due to competitive bidding is required to bid in excess of a section 506 valuation, that higher amount should represent the current value and is certainly not in excess of the true value of the property. Thus, the secured party should be able to offset against its bid amounts owing to the secured party as long as the debt equals the amount of the bid.

It is difficult to understand the reason for the exception in section 1111(b) or for that matter

the reason for the exception at all. The legislative history seems to indicate that the exception as it now is contained in the Code was inserted because the section 1111 election was unnecessary when the property was sold, since the secured party had a right "to bid in the full amount of his allowed claim at any sale of collateral under section 363(k) of the House amendment." (124 Cong. Rec. S.17420 (daily ed. Oct. 6, 1978)). However, as discussed above, it is not clear that the allowed claim for a nonrecourse secured party would equal the debt and thus the right to offset the full claim may not be as certain as the legislative history draftsmen assume. Since the elimination of the exception both from the present language and the amendment would seem to cause no harm and would avoid the problem we raise, the Council recommends deletion of the words "except where property of the estate that secures a claim is sold subject to section 363(k) of this title" in section 99 of S.863.

7. Technical Corrections. The following three provisions of S.863 contain what seem to be typographical or technical errors:

   a. Section 101(26)(B). In defining when a partnership is insolvent, section 1(f) of S.863 changes the word "and" to "or" at the end of subsection (i). This change from a conjunctive to the disjunctive was surely not intended. The definition is intended to say that a partnership is involvent when the sum of the partnership debts is greater than the partnership's assets *and* the net worth of the individual partners. With the change to "or" a partnership having asserts of $1 billion and liabilities of $300,000 would be insolvent if the individual partner's aggregate net worth were under $300,000. Also,

the disjunctive is inconsistent with the beginning of the definition in (B) which refers to the "aggregate" of (i) and (ii).

   b. Section 502(b)(7). Section 30(b) of S.863 would redesignate section 502(b)(7) as section 502(b)(6) and would add in subparagraph (A) the words "without acceleration". These words were retained in subparagraph (B) where they would seem appropriate. However, in subparagraph (A) the insert makes no sense since the amounts being referred to are rents reserved for specific periods, i.e., the rent reserved for the rental year during which the termination occurs or 15% for the remaining term of the lease not exceeding three years. It would seem that these words were included in subparagraph (A) in error and keeping them there would cause confusion as to how to apply the remainder of that subparagraph. It is therefore urged that the words "without acceleration" in subparagraph (A) be deleted.

   c. Section 507(b). This section provides that where adequate protection is given to the holder of a claim secured by a lien on real property and such adequate protection proves to be insufficient, the claim of the creditor will be given priority over every other claim allowable under section 507 (a)(1). Section 34(b) of S.863 adds language to section 507(b) apparently designed to protect parties who were denied adequate protection on the ground that such protection was not necessary, but nevertheless suffered a loss. To accomplish this, section 34(b) adds "or if the court finds that there is adequate protection of such interest by a lien on such property. . . . "

> While we applaud the purpose of the amendment, the Council believes that the language could be construed too narrowly. A creditor should be entitled to the same priority where the court incorrectly denies adequate protection as when the court incorrectly finds that there is adequate protection by reason of a lien on the property. It is therefore recommended that the above-quoted language be changed to read "or if the court does not provide adequate protection."*

We very much appreciate this opportunity to comment on the provisions of S. 863 which propose amendments to the Bankruptcy Code. If you have any questions or if I can be of any further assistance, please do not hesitate to

* This change will also avoid a conceptual problem arising out of the present language which seems to have been based on the so-called "cushion" cases where the courts have in some cases considered value of the collateral in excess of the debt being, in itself, "adequate protection". This is not conceptually correct. Section 361 indicates that adequate protection is something the court or trustee provides to a creditor whose interest in the debtor's interest in collateral is diminished by a stay, use of the collateral and the like, not something the creditor already has. The courts in the "cushion" cases should have stated the issue as a question of whether the existence of the cushion meant that there has been no decrease in the value of the secured party's interest in the debtor's interest in the property. (For the record, the Council believes that the value of the secured party's interest is decreased notwithstanding the existence of a cushion (see, for example, section 506(b) which provides that the secured creditor is entitled to post petition interest to the extent of the cushion)). The language of the proposed amendment to section 507(b) would tend to support this conceptual misunderstanding and should be changed.

contact me or Charles King, Assistant General Counsel, American Council of Life Insurance.

Sincerely,

/s/ Robert M. Zinman
Robert M. Zinman
Chairman
Subcommittee on Federal Bankruptcy Legislation
American Council of Life Insurance and
Vice-President and Investment Counsel
Metropolitan Life Insurance Company

cc: Members of the Subcommittee on Courts

APPENDIX B

United States Senate

COMMITTEE ON THE JUDICIARY
WASHINGTON, D.C. 20510

June 13, 1983

Honorable Richard Schweiker
President
American Council of Life Insurers
1850 K Street, N. W.
Washington, D.C. 20006

Dear Dick:

As you are probably aware, the Senate recently completed action on S. 445, my bill to reform the federal bankruptcy laws. The purpose of this bill was to correct defects in the Bankruptcy Code which have served to create inefficiencies and delays in the courts, encouraged needless filings, and inhibited good faith creditors in recovering upon legitimate claims. The bill, as passed by the Senate, contains a number of provisions which are of particular importance to the life insurance industry.

I am writing to express my appreciation for the invaluable contribution of two individuals, acting on behalf of the Council, who worked closely with members of my staff in framing the final legislation. Those persons are Mr. Robert Zinman, Vice-President and Investment Counsel of Metropolitan Life Insurance Company, and Mr. Charles King, Assistant General Counsel to the ACLI. Mr. Zinman and Mr. King were helpful in providing technical advice and drafting assistance, as well as liaison with important members of the industry and members of the Congress. The inclusion of language in the bill which will help protect the interests of life insurance companies

involved in bankruptcy proceedings was a direct result of the efforts of these two gentlemen, and they should be commended for their excellent work.

I trust that you are finding your new responsibilities challenging and rewarding, and I wish you continued success with the ACLI.

Sincerely yours,

/s/ Bob
BOB DOLE
United States Senate

cc: Charles King
Robert Zinman

BD:dcp

(10)

No. 90-1491

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

APPLICATION OF THE AMERICAN BANKERS ASSOCIATION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE OUT OF TIME

JOHN J. GILL III
Counsel of Record

MICHAEL F. CROTTY
Deputy General Counsel for Litigation

Attorneys for Amicus Curiae
American Bankers Association
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5026

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 90-1491

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,

Respondent.

APPLICATION OF THE AMERICAN BANKERS ASSOCIATION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE OUT OF TIME

The American Bankers Association hereby respectfully moves for leave to file a brief as amicus curiae out of time in the above entitled case.

Rule 37.3 of the Supreme Court rules provides that an amicus curiae brief may be filed, with the consent of the parties, within the time allowed for filing of the brief of the party supported. In this case, by order dated June 12, the time for filing of the Petitioner's Brief was set as July 9. Through sheer inadvertence, your amicus misread and transposed the dates, so as to believe, in good faith, that the order was dated June 9 and the brief due July 12, and the brief of

the American Bankers Association as amicus curiae in support of the Petitioner was filed on that date.

The issues raised by this case are of such importance to lenders as to have drawn a number of amicus curiae briefs from interested organizations and of sufficient importance for this Court to have granted certiorari. The amicus curiae brief submitted by the American Bankers Association complies with the provisions of Rule 37.1 in that it brings to the attention of the Court relevant matter that has not already been brought to its attention by the parties. It should not be disregarded because of an inadvertent delay in filing of only three days, where such a delay could not conceivably prejudice any party or delay or impede the ultimate disposition of this case.

WHEREFORE, the American Bankers Association respectfully moves for leave to file a brief as amicus curiae out of time and that the Court accept for filing the brief submitted on July 12.

Respectfully submitted,

JOHN J. GILL III

MICHAEL F. CROTTY

Attorneys for Amicus Curiae
American Bankers Association
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5026